Asia-Pacific
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APEC-OECD INVESTMENT SEMINAR

# WORKING TOGETHER ON INVESTMENT FOR DEVELOPMENT

DATE: NOVEMBER 14-15, 2005
VENUE: BUSAN, KOREA
HOST: APEC, OECD, MINISTRY OF COMMERCE, INDUSTRY AND ENERGY OF KOREA (MOCIE)
ORGANIZER: KOREA INSTITUTE FOR INTERNATIONAL ECONOMIC POLICY (KIEP)

APEC
2005 KOREA

Asia-Pacific
Economic Cooperation

# APEC-OCED Investment Seminar

# WORKING TOGETHER ON INVESTMENT FOR DEVELOPMENT

**Busan, Korea**
**November 2005**

**APEC Investment Experts' Group**
**APEC Committee on Trade and Investment**

**June 2006**

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# Foreword

The APEC Committee on Trade and Investment and its Investment Experts Group are very happy to be associated with the APEC-OECD Investment Seminar on "Working Together on Investment for Development". This event builds on a number of very fruitful initiatives to strengthen the collaboration of APEC and the OECD on investment issues, including a joint symposium which took place in 2004 in Pucon, Chile.

APEC and the OECD have much to offer each other on investment issues, and it is important that we collaborate to further our common understanding in this key area as well as to learn from each other's best practices in implementing policies that will help economies develop with the help of foreign investment. Since its creation, APEC has provided a useful forum for Asia-Pacific economies to advance their understanding of investment issues, and the work of its Investment Experts Group (IEG) has resulted in significant policy initiatives such as the APEC Non-Binding Investment Principles and the Menu of Options for Investment Liberalization and Business Facilitation. The IEG also produces the APEC Investment Guidebook, a useful reference tool for the business community and the wider public.

All these initiatives will hopefully feed into an ambitious APEC- OECD work plan over the next few years. There is much room for cooperation, for example, in the development of the OECD's new "Policy Framework for Investment", and APEC, because it includes both developed and developing economies, can play a significant role in bringing a unique perspective to the OECD's work on this new policy instrument.

Foreign investment is extremely important for economic development, and the APEC region is home to several economies who have greatly benefited from open and transparent investment policies. It is therefore crucial that we keep working together within APEC, and that we reach out to partners such as the OECD and other organizations represented at this seminar, to ensure that we put in place the best investment policies possible. APEC and the OECD play an essential role in providing fora where governments can work together to ensure that investment supports economic development in an open, predictable and transparent policy environment.

Alan Bowman

**Alan Bowman**
CTI Chair, 2004-2005

# Agenda

***APEC-OECD Investment Seminar***

## Working Together on Investment for Development

**Date: November 14-15, 2005**
**Venue: Busan, Korea**
**Host: APEC, OECD, Ministry of Commerce, Industry and Energy of Korea (MOCIE)**
**Organizer: Korea Institute for International Policy (KIEP)**

***Day 1: November 14, 2005***

9:00-9:30 **Registration**

9:30-9:45 **Welcoming Remarks**

- *Mr. Cho, Hwan-Eik, Vice Minister, Ministry of Commerce, Industry and Energy of Korea*
- *Mr. Satoru Sato, Representative of the OECD, Co-Chair, Task Force for the Policy Framework for Investment*
- *Mr. Alan Bowman, Chair 2004-2005, APEC Committee on Trade and Investment*

### Part I: What is Investment for Development?

9:45-10:55 **Overview of APEC-OECD Recent Developments and Future Investment Perspectives**

**Introductory Remarks by Chair (5 min/speaker)**
- *Mr. Roy Nixon, Chair, APEC Investment Expert Group*

**Presentations (7 min/speaker)**
- *Prof. Taeho Bark, Professor, Seoul National University, Korea*
- *Ms. Marie-France Houde, Senior Economist, Investment Division, OECD*

- *Mr. Torbjorn Fredriksson , Senior Economist, Division on Investment, Technology and Enterprise Development, UNCTAD*

**Discussion (5 min/speaker)**

- *Mr. Noriyuki Yonemura, CEO, Fuji Xerox, Japan*
- *Mr. Felipe Sandoval, Legal Adviser, Ministry of Foreign Affairs, Chile*
- *Mr. Manmohan Singh, Deputy Director, Industrial Development Authority, Malaysia*

**Open Discussion (30 minutes)**

10:55-11:10 **Coffee Break**

## Part II: Towards Greater Investment Mobility

11:10-12:30 **Session 1: Competition for Investment Promotion: Does Industry Targeting Work?**

**Introductory Remarks by Chair (5 minutes)**

- *Mr. Joachim Steffens, Investment Committee, OECD*

**Presentations (10 min/speaker)**

- *Mr. Michael Gestrin, Senior Economist, Investment Division, OECD*
- *Mr. Joseph Battat, Lead Investment Policy Officer, Foreign Investment Advisory Services, World Bank Group*
- *Prof. Andrew Charlton, Professor, London School of Economics and Political Science, U.K.*

**Discussion (5 min/speaker)**

- *Mr. Keh-Cheng Chang, Division Director, Investment Commission, Ministry of Economic Affaires, Chinese Taipei*
- *Mr. Han-koo Yeo, Director, Ministry of Commerce, Industry and Energy of Korea*
- *Mr. Henry Loewendahl, Director, LOC Consulting, U.S.A.*

**Open Discussion (30 minutes)**

12:30-14:00 **Luncheon**

14:00-15:30 **Session 2: The Trade & Investment Policy Nexus: Current Status in the DDA Negotiations**

**Introductory Remarks by Chair (5 minutes)**

- *Prof. Taeho Bark, Professor, Seoul National University, Korea*

**Presentations (15 min/speaker)**

- *Mr. Michael Gestrin, Senior Economist, Investment Division, OECD*
- *Mr. Edward M. Graham, Senior Fellow, Institute for International Economics, U.S.A.*
- *Mr. Bijit Bora, Counselor, Economic Research and Statistics Division, WTO*

**Discussion (5 min/speaker)**

- *Mr. Torbjörn Fredriksson, Senior Economist, Division on Investment, Technology and Enterprise Development, UNCTAD*
- *Ms. Shen Qi, Ministry of Commerce of the People's Republic of China, Department of Foreign Investment Administration, China*

**Open Discussion (30 minutes)**

15:30-16:00 **Coffee Break**

16:00-17:30 **Session 3: Corporate Governance for Investment**

**Introductory Remarks by Chair (5 minutes)**

- *Mr. Mats Isaksson, Head, Corporate Affairs Division, OECD*

**Presentations (10 min/speaker)**

- *Prof. Hasung Jang, Dean, Korea University, Korea*
- *Mr. Mats Isaksson, Head, Corporate Affairs Division, OECD*
- *Prof. Curtis J. Milhaupt, Professor, Columbia University, U.S.A.*

**Discussion (5 min/speaker)**

- *Mr. Marut Smutkochorn, Vice President, Corporate Business Development of PTT Public Co., Ltd., Thailand.*
- *Mr. Pierre Habbard, Policy Advisor, Trade Union Advisory Committee to the OECD*

**Open Discussion (35 minutes)**

***Day 2: November 15, 2005***

## Part III: APEC-OECD Cooperation

9:30-11:05 **Session 1: Rapidly Increasing Economic Integration and Investment: Benefits & Challenges**

**Introductory Remarks by Chair (5 minutes)**
- *Mr. Joachim Steffens, Investment Committee, OECD*

**Presentations (15 min/speaker)**
- *Prof. Eric Neumayer, Professor, London School of Economics and Political Science, U.K.*
- *Prof. Shujiro Urata, Professor, Waseda University, Japan*
- *Mr. Dominique van der Mensbrugghe, Lead Economist, World Bank*
- *Ms. Marie-France Houde, Senior Economist, Investment Division, OECD*

**Discussion (5 min/speaker)**
- *Mr. Bijit Bora, Counselor, Economic Research and Statistics Division, WTO*
- *Mr. Alberto Pasco-Font, Executive Director, Proinversion, Peru*

**Open Discussion (15 minutes)**

11:00-12:00 **Session 2: Lessons and Options for Future Cooperation Introductory Remarks by Chair (5 minutes)**
- *Mr. Alan Bowman, Chair 2004-2005, APEC Committee on Trade and Investment*

**Presentations (10 min/speaker)**
- *Mr. Roy Nixon, Convenor, APEC Investment Expert Group*
- *Mr. Joachim Steffens, Investment Committee, OECD*
- *Ms. Marie-France Houde, Senior Economist, Investment Division, OECD*

**Commentary (5 min/speaker)**
- *Mr. Domingo I Bagaporo, Director, Electronics and ICT Department, Industry Development Group, Philippines*
- *Mr. Nguyen Ba Cuong, Head of Division, Foreign Investment Agency of Ministry of Planning and Investment, Vietnam*

**Open Discussion (10 minutes)**

12:00-12:15 **Closing Remarks**

- *Mr. Choi, Pyeong-Rak, Director General, Ministry of Commerce, Industry and Energy of Korea*
- *Mr. Mats Isaksson, Head, Corporate Affairs Division, OECD*
- *Mr. Alan Bowman, Chair 2004-2005, APEC Committee on Trade and Investment*

# Overview and Executive Summary

## ▪ Overview

The 2nd APEC-OECD co-sponsored seminar on 14-15 November themed "Working Together on Investment for Development." Starting with an overview of recent APEC-OECD developments and future investment prospects, government officials, representatives from international organizations including APEC and OECD and academics discussed ways to better implement APEC investment principles, through joint collaboration in formulating a policy framework. Moreover, as part of the effort to improve investment climate in the Asia-Pacific region, participants shared, the best practices of corporate governance for promoting foreign direct investment and stressed the benefits of better channeling resources. The seminar provided the opportunity for participants to exchange views to seek for ways of investment promotion, such as current APEC investment facilitation initiative in cooperation with UNCTAD, through cooperation between APEC and international organizations. Possible areas for further cooperation between APEC and OECD were also discussed at the seminar, including sharing experiences of both organizations for the ways of attracting more FDI through Bilateral Investment Treaties (BITs) and Double Tax Treaties (DTTs) or through the APEC's Non-Binding Investment Principles (NBIPs). The seminar proceedings are in progress and will be available on this site as soon as it is completed.

## ▪ Executive Summary

*Part I. What is Investment for Development?*

**Overview**

The first presentation was given by Professor Taeho Bark from Seoul National University in Korea. Bark introduced some APEC investment instruments such as NBIPs, menu of options, action plans, and investments guidebook and also evaluated recent APEC investment process, which has been on a voluntary basis.

Bark pointed out that APEC has been taking some useful steps, but a lack of concrete action has made for some slow progress. But on the brighter side, Bark mentioned that international investment agreements (IIAs) have increasingly reflected APEC investment efforts in promoting investment mobility. However, it seems difficult for APEC member economies to implement these tools among themselves, as it poses serious concerns about establishing binding rules in the Asia-Pacific area.

The second speaker, Marie-France Houde, a senior economist in the OECD Investment Division, remarked that OECD economies has recently experienced a 15-20 % increase in inflows of FDI, which is much higher than non-OECD economies.

In particular, one exhibition displayed the highest inflows and outflows of FDI from OECD in 2000.

The last presentation is given by Torbjorn Fredriksson, a senior economist from UNCTAD. He brought World Investment Report 2005 and shared statistics with participants. For example, he pointed out that FDI inflows to developed economies have slightly declined, while FDI inflows to developing economies have increased by forty percent. Mr. Fredriksson emphasized that FDI from South Asia is on the rise. He has come to the conclusion that these movements resulted from market- and resource- seeking behavior. He also put an emphasis on the importance of research and development in order to create an investment-friendly environment.

Fredriksson's insightful presentation was followed by comments from two discussants. First, Noriyuki Yonemura, a member of ABAC and CEO of Fuji Xerox, talked about recommendations made by ABAC in 2004 regarding anti-corruption and financial institutions. He also suggested that integrated structure between financial institutions and government would be beneficial to effectively increase FDI at the global level. The second comments were made by Felipe Sandoval, a Legal Advisor of the Ministry of Foreign Affairs in Chile. He explained what have done in Chile in order to create the right environment too promote investment.

A remarkable result has been the creation of a highly qualified workforce - since 1999, education reform has been made at all levels and increasing coverage in primary schools has reached almost 98.6%. Mr. Sandoval concluded that private as well as public is fundamental to become a developed economy.

The next comment was made by Felipe Sandoval, Legal Advisor to the Ministry of Foreign Affairs in Chile. He explained what has been done so far in Chile in trying to create an investment-friendly environment. The last comment by Manmohan Singh, Deputy Minister of the Industrial Development Authority in Malaysia, focused on Malaysia's past investment experiences. He said that Malaysia has been organizing reforms regarding their investment policies to attract FDI.. Moreover, Mr. Singh added that he believes that focusing on the manufacturing sector has helped to increase FDI inflows. Many insightful questions were raised during the open discussion. Alan Bowman, Chair of APEC Committee on Trade and Investment, asked representatives from Chile and Malaysia if the dramatically increasing number of investments in China has worried them. Felipe Sandoval responded that those investments are based on many different reasons and motivations, and people choose to invest in China because they find it attractive. However, that does not mean that their decision would prevent them from investing in Malaysia or Chile.

*Part II. Towards Greater Investment Mobility*

*Session 1- Competition for Investment Promotion: Does Industry Targeting Work?*

The second session was chaired by Mr. Joachim Steffens, from the Investment Committee of the OECD. The purpose of this session was to discuss what is best for worldwide investment. First, Steffens proposed taking a close look at the policy framework for investment and looking at the contributions each participant has made. Undoubtedly, the OECD has been one of the main contributors to this process.

The first presentation was made by Senior Economist Mr. Michael Gestrin from the Investment Division of the OECD. Gestin emphasized the importance of looking at different aspects of investment as well as FDI in order to fully understand the topic. Gestrin presented the checklist in the PFI that covers a broad set of policy areas and added that it is important to promote the checklist that involves governmental participation. The idea of the checklist was to force an informed policy-making process based on facts and on an understanding of the current situation. Gestrin concluded by pointing out that the FDI environment paradigm has changed throughout the years. In the past, it was either market seeking or efficiency seeking, but the examples of Brazil and China have shown that economies are now focusing on both. He added that these previous experiences should alert us to the fact that we need to further improve the business environment to compete under these new circumstances.

The second presenter Mr. Joseph Battat from the World Bank provided information on recent trends in FDI, Investment Promotion and Investment Climate (IC), Cases of Investment Climate and Targeting and the lessons learned. He mentioned that recent trends show southern multinational flow is increasing and new comers such as China are emerging as important players. It is at this point that policy advocacy, which is the effort to improve the environment, is most important, in terms of both general policies and investment policies. Two cases demonstrate the importance of policy. First, the auto cluster in Thailand succeeded in attracting foreign businesses by doubling production and export amounts. It provided customized incentives, supported the development of skills and technologies and so on. Second, Chile targeted IT services. The three-legged multi-functional, mutually supportive approach helped bring in the 35 foreign investors now operating in Chile. Exports went over USD 100 million and this process created more than 2,500 jobs. Battat concluded by pointing out that well-designed target plans are necessary but not sufficient. Moreover, he pointed out that investment climate and aspects relevant to the targeted sector are quite important. Finally, Battat talked about the multi-functional investment promotion approach to targeting.

The third presenter of the session was Professor Andrew Charlton from London School of Economics and Political Science. The purpose of the presentation was to present the results of the oxford IPA survey 2004. This would be a good indicator to point out where to invest, where to benchmark, etc. Charlton showed that most IPAs target their industries and added the tendency of small countries and richer countries to target more often. The results also showed that the industries targeted the most were electrical manufacturing and industrial products. Developed countries mostly targeted service and hi-tech areas, with minimal targeting towards the agriculture sector. It seems that less developed countries were less attractive to high-tech industries for various reasons, such as low capacity. Some were concerned that IPA increases export behavior, while there were skeptics who were against the idea. But the numbers showing an actual increase of 61% proved that IPA actually worked. It was naturally more likely to attract investment inflow. Charlton concluded with the following main points. Targeting is widespread, and competition is very high. Investment choices correlate with the level of development in a country, thus affecting FDI.

Mr. Keh-Cheng Chang, division director of the Investment Commission of the Ministry of Economic Affairs was next to present the unique experiment of Taiwan for its development in the past. The economy has put a lot of effort into increasing national gains through development with sustainable growth while remaining environmentally friendly. There has been a shift in the industry from heavy industry to knowledge-based industries. And to achieve the goal of sustainable improvement, the Green Silicon Island economy plan has been set up. Chang concluded with the prediction of a bright future for the plan.

Mr. Han-koo Yeo, Director of the Ministry of Commerce, Industry & Energy wanted to share Korea's experience with FDI promotion. After the Asian crisis, Korea set a different approach from the old way, which regulated that investment should be done through foreign loan development instead of through FDI. This changed after the financial crisis to where there were legal settings in place to promote FDI and hostile M&A was even allowed. Now FDI has become a very important element of the Korean economy. Yeo pointed out that there are 3 different stages in promoting investment, and mentioned the policy implications for each. He concluded by summarizing his presentation in one short sentence. Investment promotion is an art.

Finally, Henry Lowendahl, Director of LOC Consulting was the last to make a presentation. He presented the art of attracting countries after identifying the target. The number of projects going to APEC has declined and there is growing competition from other countries. And as a result, Lowendahl advised that APEC as a region should consider global competitors more seriously. The most important things about attracting investment are the attractive services for target firms, links to target firms and networks and links to industry associations. Lowendahl emphasized the importance of recognizing IP as a sales business, in which case, the question of how to organize your sales business needs to be asked. Undoubtedly, this would have to function on an individual basis, but what he wanted us to keep in mind was that it is not Korea we're selling, but business solutions such as logistics, online gaming, and specific technologies.

*Session 2 - The Trade and Investment Policy Nexus: Current Status in the DDA Negotiations*

The topic of this session was mainly the relationship between trade and investment and the current status in the DDA negotiation.

Mr. Bajit Bora from WTO had the presentation on investment and Doha Development Agenda (DDA). He points out that although investment issue was recently brought on to the agenda formally, this is not a "new" issue, and argues that it was discussed in a complementary fashion along with the existing set of rules in WTO system. In the WTO system, we have market access provisions in the form of Most Favored Nations (MFN) and National Treatment (NT), which are government policies that affect foreign investment and dispute settlement mechanisms. However the system is not intended to cover all areas with respect to trade-related investments such as no NT status to foreign firms investing in manufacturing sectors, no discipline in investment incentives, and limited dispute settlement mechanisms. Mr. Bora believes that rules on investment incentives are very important and notes that we should question the quality of FDI, review the efficiency of our FDI policy, and see if there is a set of common rules which countries can abide by to the benefit of all involved. Mr. Bora concluded with the remark that part of a good investment policy is having a good trade policy.

Mr. Michael Gestrin from OECD started with the idea on the complementary relationship between trade and investment. In regards to establishing international rules on investment, he looked at the pre-existing trade framework. Many efforts including NAFTA were associated with pre-existing regional trade agreements that have been amended to recognize the existence of complementary feature of market opening effort between countries. OECD's Policy Framework on Investment (PFI) suggests the existence of important links between a country's trade policy and the investment environment. Gestrin concluded that the rollback of trade liberalization and the faltering of a multilateral trading system would bring negative repercussions such as reduced opportunities for international value chains, and therefore less investment. Gestrin ended his presentation by emphasizing the importance of mobilized actions on the part of governments on the multilateral trade front.

Dr. Edward Graham from the Institute for International Economics brought up the issue of M&A activities as one of the major sources of FDI, especially in developed countries, and talked about nationalist reactions to takeover movements.

Dr. Graham also talked about the damaging effects of subsidies to parties involved in transactions, and how hard is it to get rid of subsidies once they are in place. Governments implement subsidy programs to support national businesses, but businesses make inefficient business decisions in adhering to subsidy programs. Either way, both are detrimental to public welfare. He ended his presentation with the idea that multilateral rules regarding investment should be considered and put in place.

Mr. Fredriksson from UNCTAD made a few remarks on the previous presentations. Corresponding to Dr. Graham's presentation, Fredriksson suggested the need for studies that focus on the impact of multilateral and regional rules on FDI volume, and presented some specific cases as to why developing countries are reluctant to launch a multilateral framework for investment. He also emphasized the importance of quality FDI and argued that it is important to attract beneficial FDI and stay knowledgeable about the negative aspects of FDI. Fredriksson asked Mr. Bora about his perspective on GATT's function as a multilateral framework for investment and services.

Ms. Shen Qi from the Ministry of Commerce in China gave a presentation on FDI trends in China and policy measures taken by the Chinese government to attract foreign direct investments over the past decade. With its government's full commitment and strong enforcement to improve the investment environment for foreigners, China was able to become the largest recipient of FDI among developing countries. Some highlighted measures include the elimination of import tariffs and non-tariff barriers. More recently, China has been paying critical attention to the protection of intellectual property rights and committing itself to adopting international standards by making policies compatible with international rules.

Few questions were raised from the floor. Regarding the question on M&A activity in the form of FDI, Fredriksson notes that Greenfield investments are still present in developing countries and M&A activity is mostly prevalent in developed countries. Regarding a question about the WTO system and support programs to help minorities such as farmers, Mr. Bora explained again that the WTO is not an institution that writes or sets the rules, thus support system is a result of legislation process.

*Session 3 - Corporate Governance for Investment*

Mats Isaksson, head of the OECD Corporate Affairs Division, talked about basic OECD principles of corporate governance. He explained a few details of the segment investment process and addressed the importance of investors' understanding of investment opportunities in order to better locate their capital. Mr. Isaksson said that OECD member countries recently agreed on new principles of corporate governance, and gave an overview of the link between corporate governance and actual investment in the respective company.

Also, Professor Hasung Jang, Dean of Korea University Business School, gave words on corporate governance and competitiveness. He briefly summarized how better corporate governance leads to better corporate performance, according to recent research.. As shown by the corporate governance index by the World Economic Forum and also by the CLSA corporate governance score, Mr. Jang concluded that Asia has been experiencing poor corporate governance. He gave a list of reasons as to why this has happened - concentrated ownership, weak protection of shareholders and weakness of regulatory enforcement.

The next presentation was made by Professor Curtis Milhaupt from Columbia Law School. He commented on the Asian experience regarding corporate governance and FDI. Mr. Milhaupt analyzed some reasons behind bad corporate governance incidents in Asia, such as stakeholders and group orientation, as well as family influence. Although corporate governance is considered to be one of the most important elements in determining FDI inflows, he explained that China's case proves that corporate governance is not the only predictor of an FDI decision. Rather, some investors protect themselves from negative results stemming from poor corporate governance using tools such as trusted local partners and green field investment.

Two discussants made thoughtful comments on the given presentations and issues discussed. The first discussant, Marut Smutkochorn, Vice President of Corporate Business Development of PTT Public C., Ltd., in Thailand gave a PTT overview and talked about some good corporate governance principles. He introduced PTT as an important mandate for Thailand and said that PTT has enhanced organizational effectiveness and transparency by promoting a positive corporate image.

Also, Pierre Habbard, the Policy Advisor of Trade Union Advisory Committee to the OECD, provided a different perspective on the corporate governance issue. He emphasized workers' rights and their relationship with corporate governance, and added that there should not be any one model for good corporate governance.

Mr. Habbard said because the structure of corporate governance is very complex, it would be detrimental to impose one standard model to different organizations.

Following these remarkable presentations, participants shared their thoughts. Professor E. Neumayer from the London School of Economics and Political Science asked how difficult it was for policy makers to change corporate governance methods. Other parts of public sector have been extremely difficult to change, and he was wondering if Mr. Milhaupt could suggest whether or not there existed a shortcut to changing corporate governance methods for the better.

Professor Milhaupt answered that by changing corporate and securities law, government officials should be able to achieve their goal. However, he admitted that improving corporate governance would not be an easy issue. Examples such as OECD guidelines might help in effectively changing corporate governance, but such changes would take a long time.

## *Part III. APEC-OECD Cooperation*

### *Session 1 - Rapidly Increasing Economic Integration and Investment: Benefits & Challenges*

Following brief introductory remarks by the Chair, Joachim Steffens from the Investment Committee in OECD, Professor Urata from Waseda University in Japan gave his presentation on FDI and economic growth in the Asia-Pacific area. In addition, he stressed the important role of APEC in promoting FDI within member countries and consequently, at the global level. Professor Urata indicated that a significant portion of investment in Asian countries has been made in the form of reinvestment, and that East Asian countries have successfully liberalized FDI policy to attract more FDI in accordance with non-binding investment principles (NBIP). He also gave a list of the main determinants of FDI in order to suggest ways to promote investment. Professor Urata concluded with the importance of FDI to Asia-Pacific economies and the necessity of the promotion of economic growth through enhancing trade, production and technology.

Professor Eric Neumayer from the London School of Economics and Political Science analyzed the impacts of bilateral investment and tax treaties on FDI. He spoke about the popularity of Bilateral Investment Treaties (BITs) and Double Tax Treaties (DTTs) since 1960. He mentioned both the costs and benefits of BITs and DTTs for developing countries and summarized his study results, which states that developing countries that sign more BITs and DTTs receive more FDI.

The third presenter, Dominique Van der Mensbrugghe from the World Bank focused on the implications of regional trade agreements (RTAs) for trade and investment. He introduced some controversial issues regarding the relationship between RTAs and the overall volume of trade in a given area, and concluded that, in general, open regionalism works best.

Mr. Mensbrugghe illustrated that RTAs frequently contain ample investment provisions but differ markedly across the board. However, he highlighted the fact that RTAs do attract more FDI flows by providing a good investment climate.

Also, Marie-France Houde from the Investment Committee in OECD shared some data on the relationship between the volume of investment and the number of OECD agreements. In particular, she carried out research on how much investment is governed or caused by such treaties.

She found that OECD investment agreements not only protect OECD outward investments but also investments into OECD countries.

Following these four presentations, Bijit Bora, the Counselor of Economic Research and Statistics Division, summarized general insights that had been made thus far. He commented that investment is very difficult to indicate the degree of protectionism because, for example, one country might be more protective specifically toward FDI inflows than others. Regarding Professor E. Neumayer's presentation, Mr. Bora said that DDTs have an almost neutral effect on FDI inflows or outflows.

The second discussant, Alberto Pasco-Font, Executive Director of Proinversion in Peru spoke about the impacts of policy and legal mechanisms on investments and imports in Peru. He mentioned that Peru has long been pursuing free trade agreements (FTAs) with other countries and has tried to promote an investment-friendly infrastructure. Mr. Pasco-Font described how Peru has been aggressive in implementing FTAs by undertaking reforms on the tax system and legal frameworks.

Many insightful questions were raised during the open discussion. Fredriksson asked about the relationship between RTAs and the international service sector. In response, Mr. Bora briefly described the first provision on the international service sector in the 1980s in Canada, and how it has developed since then. Professor E. Neumayer mentioned that the existence of investor stake disputes are unrelated to changes in overall FDI inflows. He also admitted that the causality between FDI stocks and FTAs would be difficult to determine.

*Session 2 - Lessons and Options for Future Cooperation*

Roy Nixon briefly introduced the history of cooperation between APEC and OECD in the area of international investment, including the current APEC investment facilitation initiative in cooperation with UNCTAD and other multilateral institutions. He concluded that APEC and OECD are a natural fit for a continued policy dialogue. The next presentation was given by Mr. Joachim Steffens from the Investment Committee in OECD. As part of an effort to create an investment- friendly environment, he emphasized the importance of reinforcing gains through domestic deregulation and providing greater protection for investors.

Ms. Marie-France Houde highlighted ways to put the suggestions raised thus far into practice. She stated that peer reviews in the economy concerned have proven to be particularly suited for building policy capacity. In addition, Ms. Houde stressed that peer reviews should involve government officials who would be responsible for policy changes.

Because peer review in APEC is still in the beginning stages, she emphasized the need for cooperation with OECD. As part of future cooperation between APEC and OECD, she suggested that APEC's experience with the implementation of the Bogor goals could be integrated into OECD's efforts with the Policy Framework for Investment.

Two commentaries followed after the brief summary made by the Chair, Mr. Alan Bowman from the APEC Committee on Trade and Investment. Mr. Domingo I. Bagaporo, Director of Electronics and ICT Department under the Industry Development Group in Philippines, further discussed important options presented earlier. In particular, he focused on issues relating to the relaxation of the remaining foreign ownership restrictions in order to promote the free flow of capital, which will result in significant gains in the economy concerned. Mr. Bagaporo also spoke about successful legal-framework reforms to promote FDI flows in Philippines.

The second discussant, Mr. Nguyen Ba Cuong, Head of Foreign Investment Agency under Ministry of Planning and Investment in Vietnam, talked about upcoming APEC-OECD seminars and other international gatherings,

which will focus on regulatory reforms in the area of international investment in Vietnam next year.

He suggested ways to cooperate with OECD to promote investment liberalization in the Asia-Pacific region, including referring to some research previously conducted by OECD. Mr. Ba Cuong stressed the importance of further discussion in the area of public governance.

# Welcoming Remarks

Mr. Cho, Hwan-Eik, Vice Minister, Ministry of Commerce, Industry and Energy of Korea
Mr. Satoru Sato, Representative of the OECD, Co-Chair, Task Force for the Policy Framework for Investment
Mr. Alan Bowman, Chair 2004-2005, APEC Committee on Trade and Investment

# Welcoming Remarks

***Hwan-Eik Cho***
Vice Minister
Ministry of Commerce, Industry and Energy of Korea

Mr. Alan Bowman, Chair of APEC Committee on Trade & Investment Liberalization, Mr. Satoru Sato, Co-Chair of the OECD Investment Policy Framework of Investment, Distinguished delegates from the WTO, UNCTAD, the World Bank, and APEC economies, I am very happy to see that this APEC/OECD Seminar on global liberalization of investment has come about through the joint efforts of APEC, the OECD and the Korean Ministry of Commerce, Industry and Energy. Participating in the Seminar are prominent Korean scholars such as Professor Hasung Jang from Korea University and Professor Taeho Bark from Seoul National University. I am sure that their active participation promises to make this seminar even more productive.

APEC was launched in 1989 to liberalize and facilitate trade and investment, and to expand economic and technology cooperation. APEC economies account for 57% of global GDP and 46% of global trade. Furthermore, APEC has grown to be the largest regional cooperation body, and its members enjoy dynamic growth, attracting 41% of global inbound foreign investment. The OECD was launched in 1961 to promote economic and social development through policy coordination and cooperation among its members. The OECD member countries play a leading role in development of the global economy, representing 81% of global GDP, and 70% of global trade. During this Seminar, experts from APEC and the OECD will be discussing issues concerning liberalization and facilitation of global investment. I believe this Seminar is particularly significant: being held on the eve of APEC Investment Opportunities 2005, which is opening in conjunction with the 13th APEC Summit Meeting.

As you know, Foreign Direct Investment is an important aspect for open economies and a major catalyst in economic development. To attract FDI, many countries are working to meet global standards and improve their investment environments. Korea, for example, has brought about many conditions that are conducive for investment. It has fully liberalized restrictions on foreign investment and has introduced a one-stop investment service agency exclusively for international investors. Now, Korea is attracting FDI so that it will help Korea build an advanced industrial structure and enhance its competitiveness.

FDI was the reason Korea was able to overcome the foreign exchange crisis as quickly as it did. For successful recovery from the crisis and fully restoring Korea's international image, the UN recognized Korea as a model for developing countries. Foreign companies taken root in the Korean economy and now account for 11.6% of domestic sales, 6.6% of employment, 14.3% of manufacturing exports and 13.7% of manufacturing imports. For the next two days, this Seminar will focus on the theme of Investment for Development. Investment experts from around the world will share their views on investment liberalization and facilitation. I am sure that the discussions held in this Seminar will contribute to the development of not only APEC economies, but also the global economy. Before I conclude, I thank you for participating in this event in Korea and look forward to picking up where we will leave off next year in Vietnam.I hope your discussion will be productive and that your stay in Busan is enjoyable. Thank you.

# Welcoming Remarks

***Satoru Sato***
Representative of OECD, Co-Chair
Task Force for the Policy Framework for Investment

Mr. Cho Hwan-Eik, the Vice Minister of Korean Ministry of Commerce, Industry, and Energy, Mr. Alan Bowman, CTI Chair of APEC, distinguished guests, ladies and gentlemen, first of all, I would like to sincerely thank the Korean government, more particularly the Ministry of Commerce, Industry, and Energy, and KIEP, as well as APEC for organizing this seminar in partnership with OECD. Today, it is my great pleasure to have this opportunity to speak on behalf of the OECD. The OECD is in the progress of completing one of its most ambitious undertakings to date, namely the development of policy framework for investment (PFI). Under the OECD strategy for developing, this initiative began as a result of proposal made by Japan at the OECD ministerial council meeting in 2003. From that point on, Japan and Chile became the co-chair of taskforce responsible for carrying out this work. Theses are the reasons why I was given this honorable opportunity to speak today. Japan utilizing United Air force between government and business made great efforts to promote industries and subsequently achieved the construction with support from private investment activity. The recent development in the East Asia, South East Asian region has also been supported by private investments.

Japan has been consistently developed within the development community within the importance of private investment for development and has put it arguments into practices to OECD programs by supporting the air force of developing countries to promote private activities and industries. I feel that the debate regarding the private investment was gradually put into motions in the 1990s, and then in 1992, the Monterey Consensus contributed the central role to private investment in the achievement of Millennium Development Goals. This was a critical turning point in recognizing the importance of private investment for development. Japan welcomed this situation in which the view of development community had become consistent with Japan's view and the experiences of Asian development. Subsequently in keeping with the trend of time, Japan proposed the initiative of investment for development at the OECD ministerial council meeting in 2003. I would like to take this opportunity to introduce the OECD policy framework for investment (PFI).

The PFI is intended as comprehensive to force the whole-of-government approach to policy formulation and implementation for the sake of greater coherence, consistency, and effectiveness of pro-investment policies. It is quiet remarkable indeed that the PFI does not propose policy prescriptions rather it is intended as a reference point which governments will be able to use to guide the formulation of policy standards in all areas bearing investment climate. This comes in the form of checklist of questions for self evaluation of PR dialogue vis-à-vis to identifying and implementing improvements that has been taken into account the particular circumstances on the level of development of countries undertaking policy reforms. The seminar will discuss at length three cooperative chapters of PFI, namely investment promotion, the interface between investment policy, trade policy, and corporate governance. This discussion is very timely because it just completed mid term progress for all our goals which highlights more robust interaction on relevant policy areas including that influence investments.

There are sticking similarities between the objectives, principles, and working methods passed by APEC and the OECD in the investment field and as a great value in joining forces. I am sure this seminar will provide the inspiration for how this can be done. In reviewing the FDI outflow in 2004, 60% was invested from the economies of the APEC and the OECD and taking into consideration, in fact 50% of FDI outflow was from the OECD member countries. On the other hands, 70% of total FDI inflow was brought about by the economies of APEC and the OECD member countries. Only the economies of APEC received 50% of total FDI inflow. Each country and each international organization should make efforts to promote private investments. In order to do that, there should be the sound investment activities of multinational enterprises and at the same time encourage improvement of investment climate by host countries. APEC, OECD member countries, and non-member countries are working together in the framework are indeed the point of contact between FDI outflows and inflows on the place of interaction. Accordingly, it is important to put the outcome of research or discussion in the OECD to derive of APEC, it is also important to apply the knowledge derived from APEC experiences to the activities of the OECD. The policy framework for investment, PFI, has no comparing force. I believe that it will be an investment promotion to the proposal of ideal investment policies with the understanding, support, and cooperation for implementation provided by host developments. In order to make PFI such a fundamental tool, we should work on improving it. Much more exchange of views between stakeholders on many more occasions is needed to achieve such an improvement. With that in mind, I hope that the cooperation between APEC and the OECD will be further strengthened. Finally, Let me express my deepest thanks to all of speakers and participants brought the here today from the governments, from the international organizations, from business and academic circles. This gathering is truly impressive and I wish all the success it deserves.

# Welcoming Remarks

***Alan Bowman***
Chair 2004-2005
APEC Committee on Trade and Investment

Good morning everybody and thank you for all being here, I am the third person to welcome you here, thank you for the participation in this event, which I am sure will be extremely interesting, the agenda looks extremely promising, and I am happy to see that we have so many prominent speakers and experts assembled here. Unfortunately, I am not the one of those prominent experts; I am not the investment expert. My role is as the Chair of APEC committee on trade and investment, what we call CTI, I am this year Canada chair and I've been appointed as the chair of that committee for the year. For those of you who are not familiar with APEC Committee on trade and investment, it is somewhat like the equivalent to OECD trade committee and OECD investment committee combined. We actually combine the two issues into one committee in APEC rather than looking at them separately. But we oversee 15 sub committees in the committee on trade and investment on issues such as services, custom procedures, intellectual property, we also have industry dialogue.

We are actually fairly a large umbrella committee for the all of the works that the APEC does and one of the sub committee is the investment experts group which is chaired by Roy Nixon from Australia. He is here as well today and I am sure Roy can speak a lot more about the programs of IEG. But what I would like to talk to you a little bit today is how APEC's work on investments fits within the bigger framework on what APEC does on trade. I think it is important to note that this seminar is taking place at the same as the APEC summit and APEC ministerial meeting, so I like to tell you a little bit about what is going to happen in Busan this week and what our leaders and ministers will focus on, now that will impact on the investment experts group of APEC does and how that will impact on future collaboration between APEC and the OECD. If you read the papers, you will see that our leaders and ministers this week will discuss the WTO. This will be the major outcome on the trade side of the APEC's agenda. As you know, APEC's agenda now is much broader than just the trade issue. We have a comprehensive security agenda; we discuss the issues such as conflicts regarding terrorism, Asian flu, health security, but on the trade size, this time, all the newspapers and all the headlines will be about the WTO. Our ministers and our leaders will come here and try to do something to put the Doha Development Agenda on track with the Hong Kong ministerial in just few weeks and recent fairly, not so positive developments in Europe, we want to see if APEC can issue very strong political statement about the importance on Doha Development Agenda and of the need to make Hong Kong ministerial successful. That's what you are going to hear in the media, that's what our ministers and leaders will focus on the large part. But you should also understand APEC does much more than try to support the WTO. If you look beyond the headlines and summit documents at the conclusions of ministerial meetings, you will see that APEC this year has done a lot of work to think about its role on trade and investment issue. We did something under the leadership of Korea actually, the organization that is organization this seminar in cooperation with APEC and the OECD, KIEP, I see Dr. Kim here, has done a lot of work to evaluate the performance of APEC on trade and investment issues. We did what we call mid term stock date. APEC was existed since 1989, and we decided to look at what we have done on trade since 1989 and where are we, and where do we want to go. That document will be unveiled at the time of summit. I won't tell you everything in it because it is supposed to be embargoed but the main conclusion really is that APEC is roughly on the right track in terms of being a cheerleader for promoting multilateral trade talks but it also says that APEC agenda perhaps be better focus on few issues.

We have a very wide agenda and we have limited resources. Unlike the OECD, we have a very small Secretariat. So all of the substantive work that is done in APEC is done by member economies. We don't have the benefit of having it, for example to support our work. We have to do those ourselves. So with the limited resources, how do we make sure that APEC delivers on trade, and one of the major conclusions is that the trade facilitation agenda is perhaps too broad and needs to be focused on very short number of key issues on which we will be able to demonstrate real progress. Another conclusion of midterm stocktaking is that we haven't done enough on investment. APEC made focuses has been supporting the round, investment has been left out of Doha Development Agenda, and so we focus on other things in recent years. But the given the importance of investments in APEC region and as Mr. Sato explained, the figures he gave us were quiet convincing, we cannot forget about the investment in APEC.

Over the last two years on all honest, urge down the investment were lacking for various reasons but partly because there was a transition in chairman in IEG, investment expert groups. The arrival of Roy Nixon about a year ago has given a new light to APEC's work on investment. The fact that we are organizing the event like with the OECD is quiet encouraging and promising for the future. That need to work more on investment will be recognized in the summit document this year. There will be a specific language, I am not sure exactly what it is going to say because it is still negotiating, but it is going to say something like APEC needs to look at investment principles that we developed 10 years ago and deepened the implementation or perhaps we need to look at them with the new light and try to see if what we've done in 10 years ago is still valid today and whether they need to be expanded. So there will be a specific instruction in summit document asking Roy and his groups to actually try to move forward the key investment issues. As I said that's still under negotiations and there are differences of views. I was in the senior officials' meeting yesterday and not everybody agreed that exactly what we should do. Broadly speaking, it's going to be looking at the investment principles, also the investment transparency standards that were adopted a year and a half ago and see whether we can forward on implementation and also perhaps expand them.

So how do we do this? One of the key mechanisms for better implementation of APEC investment principles is, in my view, the development of peer review mechanism. I don't know if we can go as far as the OECD in terms of establishing peer reviews but it is important that APEC acts as a mechanism to which investment policies of its different members are reviewed on regular basis with the view of leading to improvements. I am not talking about controversial reviews or adversarial reviews, I am talking about cooperative reviews where APEC without its members, especially the members of APEC that are not members the OECD because the members of the OECD have access to a lot of resources in the OECD to improve their investment climate but non-members of the OECD and APEC has lot of countries, economies that are the members of the OECD could perhaps benefit from more targeted capacity building assistances and better channeling APEC's limited resources. They are limited but they are not completely absent, APEC has 5 million dollar budget for year for capacity building so there is a lot of capacity building we can do with that and very little of that money has been spent on investment in the last few years.

So how can we make the case to better use some of those resources to support the economies in APEC that are members of the OECD and their efforts to improve investment climate? Here I am talking about countries like China and Indonesia, or other economies in Southeast Asia will depend tremendously investments for economic growth. In the next while, world leaders will issue this Busan road map, I encourage all of you to read it carefully and to perhaps do a quick search for investment, that's going to be a very long document but try to find the paragraph on investment and see how we can all, I would encourage Roy and perhaps Marie-France Houde, Mr. Sato and others in the OECD to sit down and look at what that means for APEC but also what that means for APEC and the OECD cooperation. I think in the last few years what we've done is organizing joint conferences. We've done one very successfully in Chile last year and some of you were participated in it. But how can we go beyond doing joint conferences, is there joint capacity building we can do, is APEC going to be serious about putting in place the peer review mechanism, how can we use the resources of the OECD to put that in place. I think we don't want to put reinvent the will but we want to work with the OECD to make sure that the excellent work you've done for your members gets broadened to APEC's membership.

Obviously joint collaboration on the policy framework that the OECD is working on is the key to fulfill collaboration. I think I will end here. Thank you again for all being here on behalf of APEC, I welcome you to this event and I would like to thank all the organizers, KIEP, the OECD, IEG, but everybody else who has been involved in organizations for putting in place for so rich a program. I look forward to being with you for the next few hours. Thank you very much.

# Part I

# What is Investment for Development?

# Overview of APEC-OECD Recent Developments and Future Investment Perspectives

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**Presentations**

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Ms. Marie-France Houde, Senior Economist, Investment Division, OECD
Mr. Torbjorn Fredriksson , Senior Economist, Division on Investment, Technology and Enterprise Development, UNCTAD

# Overview of APEC-OECD Recent Developments and Future Investment Perspectives

***Taeho Bark***
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## 1. INTRODUCTION

The past quarter century has been a time of investment liberalization, promotion and protection. Host countries seek to attract foreign investment by offering various incentives and guarantees to international investors. Indeed, following this trend, bilateral investment treaties (BITs) have continued to be negotiated in increasing numbers, so that by the end of 2004 a total of 2,392 treaties had been concluded.[1)]

BITs were originally agreements concluded between a developed and developing country. In the 1990s, however, BITs between developing countries or between developing countries and economies in transition have become much more common. The APEC region has emerged as one of the major regional economic groups in the world economy, assuming 57.4% world GDP and 44.7% of world trade volume, respectively.

The composition of APEC, with its diversity in economic development stages and heterogeneous industrial structures, offers a chance for APEC-internal agreements to spill over into the multilateral trading and investment system. In this context, this paper wishes to discuss two main issues: first, how relevant APEC investment instruments and second, how these instruments have been reflected in various international investment agreements, particularly among APEC member economies. For the purposes of the paper, APEC investment instruments are defined as the Non-binding Investment Principles and the Menu of Options and the different types of international investment agreements considered are multilateral, regional, prototype and bilateral investment agreements.

In the paper, international investment agreements are categorized into four different types. They are the multilateral treaties of WTO GATS/TRIMs/TRIPs and the World Bank Group's MIGA; the regional treaties of NAFTA and ASEAN; the prototype bilateral investment treaties of Australia, Chile, China, Indonesia, Malaysia, Chinese Taipei and the US; and finally, the bilateral investment treaties between Canada-Chile, Hong

1) See UNCTAD (2005), World Investment Report 2005.

Kong-Australia, Hong Kong-Japan, Hong Kong- Korea, Korea-Japan, New Zealand-ingapore, Thailand-Canada, Thailand- Chinese Taipei, and US-Vietnam, Japan-Singapore, Russia-Thailand, Japan-Vietnam, Korea-Vietnam. This is by no means a comprehensive list of all APEC member investment treaties, but these have been chosen as a sampling of APEC economies in different stages of development.

This paper consists of four sections. Section II seeks to review the general characteristics of the different types of agreements among APEC member economies and in section III, the APEC investment instruments are examined. Section IV analyzes the investment agreements with the APEC investment instruments. And finally, section V concludes with possible policy implications for the further liberalization of investment in the region.

## 2. TYPES OF INVESTMENT AGREEMENTS

*Multilateral Agreements*

The Punta del Este Declaration, which launched the Uruguay Round, included a set of discussions in the area of investment deemed to have restrictive and distorted effects on trade. In the Uruguay Round, however, investment *per se* was not on the negotiating agenda. However, the Final Act of the Uruguay Round contained a number of provisions dealing with issues, which were related to investment liberalization and protection. They are found in the General Agreement on Trade in Services (GATS), Agreement on Trade-related Investment Measures (TRIMs), and the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs).

The most important of these is the General Agreement on Trade in Services (GATS). This provision addresses the terms and conditions upon which an investor may enter a market, and the conditions of operation in the post-establishment phase. With regard to "establishment," the most-favored-nation (MFN) commitment applies, but beyond that GATS market access concept permits governments to condition the extent to which (non-discriminatory) entry by foreign suppliers will be permitted.

With regard to post-establishment, by defining "national treatment" as an obligation that relates only to scheduled commitments and not as a principle of general application, GATS is different from a number of other inter-governmental investment agreements in which national treatment has the same status as MFN. Moreover, GATS provides for national treatment to be granted only partially, or subject to specified conditions.

The TRIMs Agreement derives from Articles III and XI of the General Agreement on Tariffs and Trade (GATT). One of its primary objectives is to facilitate investment across international frontiers. It states that World Trade Organization (WTO) members shall not apply measures which require investors or producers to purchase their inputs locally to the exclusion of competing imported products (typically called local content requirements), or to sell their output domestically rather than exporting it (typically called domestic sales requirements). The aim in both cases is to discipline measures, which restrict or distort trade flows.

The TRIPs Agreement is regarded as a strong rule-based agreement likely to generate positive investment protection despite no detailed provisions dealing directly with the treatment of investment *per se*. It provides further protection for intangible assets that form the basis of the activities of multinational firms.

The Multilateral Investment Guarantee Agency (MIGA) was established in 1988 as a member agency of the World Bank Group to encourage foreign direct investment in developing countries. It provides investment guarantees to investors against the political risks of transfer restriction, expropriation, breach of contract, war and civil disturbance in the host country and technical assistance to host governments on means to enhance their ability to attract foreign direct investment.

In 1995, the Organization for Economic Co-operation and Development (OECD) Ministers agreed that to deal with the trend of globalization, there was a pressing need for a multilateral regime on investment, which offered a uniform, stable and predictable environment. Thus, negotiations on the Multilateral Agreement on Investment (MAI) began in 1995 among "like-minded" countries. It was expected to be the first multilateral agreement which combined all main disciplines in the key areas on foreign direct investment rule-making: especially, investment protection, investment liberalization and dispute settlement. Members emphasized the open character of the MAI allowing for accession by non-OECD members. Throughout the meetings, there were shared dialogues with business and labor and with non-governmental organizations. However, the MAI negotiations eventually fell apart in December 1998 despite three years of negotiations. This experience suggests that international investment agreement is not an easy sector to conclude even among developed countries with seemingly similar interests.

Since 1997, WTO members have started to analyze the relationship between international trade and investment, and its implications for economic growth and development. The Working Group on the Relationship between Trade and Investment have examined a range of international investment instruments and existing agreements and have debated the possible pros and cons of negotiating a multilateral framework of investment rules in the WTO.

*Regional Agreements*

Regional economic integration agreements are a significant subcategory. They often involve a higher than usual degree of unity and cooperation among their members and sometimes are marked by the presence of "supranational" institutions, and it is therefore difficult to draw general conclusions from their provisions. Regional instruments have some of the characteristics of multilateral ones: the agreement of many countries is needed for their negotiation and conclusion, they often have important institutional structures and the generally provide for their continuing growth and development. However, the number of countries involved is smaller and they tend to be relatively homogeneous; the adoption of instruments that serve common interests in fairly specific fashion is more feasible. With respect to FDI, regional agreements have helped to change pre-existing structures of law and policy and to create important patterns of expectations on a broader transnational level, even though not a universal one.

The North American Free Trade Agreement (NAFTA) was signed in 1992 between Canada, Mexico and the US. As a regional agreement, it is not limited to developed countries only and may indeed be extended to other countries. At first, APEC member economies expressed some anxiety lest NAFTA turn into a protectionist trade bloc. However, members reiterated their belief in ‘open regionalism’ and endorsed the view that regional and sub-regional trade arrangements should be outward-looking, GATT-consistent and support the process of broader trade liberalization. Indeed, NAFTA’s provisions on the subject of foreign direct investment (FDI) have significantly influenced other arrangements. It may in fact be considered as a characteristic of a recent trend for free trade agreements to include FDI in their scope. While the agreement covers only three states, their size and overall importance as well as the process of liberalization the agreement has set in motion, make it a particularly important treaty.

In October 1998, the governments of Brunei Darussalam, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam- the member states of the Association of South-East Asian Nations (ASEAN), concluded the Framework Agreement on the ASEAN Investment Area with a view to creating a more liberal and transparent investment environment in the area. This Agreement is focused on FDI alone. It seeks to promote investment in the area through the cooperation of the countries in the region in the liberalization of investment regulations, the provision of national treatment to all investors from the countries involved, increased transparency and an interstate dispute-settlement system.

*Prototype Investment Treaties and Bilateral Investment Treaties*

Bilateral investment treaties have been formed to date, covering all corners of the globe. They were first introduced in the 1960s and have since remained largely unchanged in terms of their format and the issues they cover. These treaties focus solely on investment issues and make binding provisions on expropriation, compensation of losses due to armed conflict or internal disorder, and for the transfer of payments. Typically, these benefits are accorded on a national treatment or MFN basis. The definition of investment used is broad, covering both non-equity forms of investment and portfolio investment. Protection is only granted to investors with real links to one of the two partners to the agreement.

BITs can be tailored to the specific circumstances of the two parties more easily than other types of agreements, are relatively easy to conclude, and therefore can be realized more quickly than regional and multilateral agreements. Some of the disadvantages of BITs are related to the fact that a bilateral negotiation between parties with unequal bargaining power may disproportionately favor one party's interests. The proliferation of BITs may also lead to a complex web of inconsistent provisions that are difficult to apply and may distort investment flows. Furthermore, in contrast to their specificity with respect to investment protection, BITs are short on commitments on the liberalization of investment restrictions. Still, BITs may have a contributory role in the elaboration of regional and multilateral rules if the two types of agreements can be seen as mutually reinforcing.

## 3. APEC INVESTMENT INSTRUMENTS

The case for new international rules to govern investment is built on four premises: that globalization is increasing, global firms face national policies, conflicts are inevitable, and the goals of both global firms and governments are legitimate.. While international investment agreements by definition contain obligations that, by their very nature, limit to some extent the autonomy of participating parties, the need for a certain degree of flexibility to allow countries to pursue their development objectives in light of their specific needs and circumstances must be addressed. The non-binding nature of the APEC investment instruments, the non-binding investment principles and the menu of options specifically addresses these challenges.

*Non-binding Investment Principles*

The Non-binding Investment Principles (NBIP) was adopted in Bogor, Indonesia in 1994 as an investment code for facilitating investment flows within the region. As the code is non-binding some commentators argue that the NBIPs amount to a weak instrument for achieving a free and open investment regime in the region. Nonetheless, all recognize the code as a useful first step towards this end. The following is a list of investment principles set out in the investment code: transparency, non-discrimination between source economies, national treatment, investment incentives, performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes, entry and sojourn of personnel, avoidance of double taxation, investor behavior and removal of barriers to capital exports.

*Menu of Options*

In 1997, in response to both government and business, the Investment Experts Group (IEG) at St. Johns, Canada, drafted the Menu of options to help economies identify policy measures that they may include unilaterally in their individual action plans. There was a consensus that the project should focus on concrete measures and the APEC ministers endorsed the Menu initiative at Vancouver. The Menu is devised so that APEC member economies may voluntarily select any of a number of options in order to make progress towards creating a free and open investment regime. It was intended as a reference tool for economies to refer to when updating their individual action plans (IAPs). The APEC approach to liberalization and facilitation of trade and investment is to recognize the diversity that exists among APEC member economies. The Menu of Options is consistent in this goal, recognizing diversity and providing members with a broad range of choices suitable for different circumstances. The items are not prescriptive and, where chosen, may be modified to suit particular circumstances. Since its initial drafting, the Menu of Options has been expanded by the IEG with the addition of texts on technology transfer, intellectual property rights, start-up companies/venture capital and domestic business environment so as to capture the benefits of APEC economies' increasing experience and changing views. The list of Menu items include: transparency, non-discrimination related to MFN and national treatment, expropriation and compensation, protection from strife and similar events, transfers of capital related to investments, performance requirements, entry and stay of personnel, settlement of disputes, intellectual property, technology transfer, avoidance of double taxation, start-up companies and venture capital, competition policy and regulatory reform and business facilitating measures to improve the domestic business environment.

It can be said that APECs NBIPs and Menu of Options follow standards that have come to be known as "soft law." These standards are not always legal in the traditional sense, in that they are not formally binding on states or individuals, but they may still possess considerable legal and political authority, to the extent that they often represent widely held expectations that affect in a variety of ways the actual behavior of economic and political actors. The exact legal status of soft law has long been a matter of controversy. To the extent that such standards represent widely shared expectations, they may, through repeated invocation and appropriate utilization, move to the status of becoming binding and enforceable rules.

Furthermore, the APEC process relies on a consensus-based approach, which promotes discussion of wide ranging initiatives. While members may not implement these initiatives immediately, regular meetings and reports and the peer pressure associated with these provides impetus for member countries to be seen to be doing something substantial to liberalize their investment regimes. As Graham points out, the APEC experience in crafting investment principles demonstrated two things. The first was that a diverse group of nations, including some of the most dynamic of the newly industrializing economies, were willing to discuss and international convention on direct investment. The second was that although these principles are non-binding, it does represent the beginning of a dialogue.[2)]

In its review of the provisions of the NBIPs in 1995, the Eminent Person's Group (EPG) suggested that five of the provisions, namely, transparency, non-discrimination, expropriation, settlement of investment disputes and tax measures, were the equivalent of international practice in investment treaties. However, the Group claimed that five provisions- relating to national treatment, performance requirements, investment incentives, repatriation and convertibility, the entry and sojourn of foreign personnel – failed to measure up to international best practice standards[3)].

*Investment Guidebook and Individual Action Plans*

While not considered as investment instruments *per se*, the Investment Guidebook and Individual Action Plans (IAP) serve as useful tools in revealing to investors an economy's investment regime. The Collective and Individual Action Plans were to put in place specific measures that could be taken by individual economies and by APEC collectively to promote trade and investment liberalization, trade and investment facilitation and economic cooperation. Individual and collective actions are to take place across a broad range of areas, such as those included in the NBIPs and menu of options. The IAPS are voluntary commitments submitted by each member economy to liberalize and facilitate trade – primarily through a lowering of tariffs and other barriers – and to liberalize rules for foreign investment. The APEC Business Advisory Council (ABAC) points to two specific needs in IAPs. One is the need to be more transparent in setting out the steps that economies intend to take to achieve liberalization and the policy intention behind those steps. The other is the need to be more specific as opposed to making vague suggestions about "adhering to the non-binding investment principles." It also recommended that the contents of the action plans be more user-friendly. Furthermore, ABAC has suggested that the action plans were not comprehensive in that they did not take into account liberalization measures that had been adopted since the Asian financial crisis in 1997. ABAC claims that concrete liberalization initiatives need to be set out along with a timetable for their implementation. These criticisms suggest that translating good intentions into concrete action is very difficult in the investment arena[4)].

The Investment Guidebook published by the APEC Secretariat serves as a useful guide on the laws most relevant to investment. However, the information provided in the guidebook depends almost entirely on the information that member economies provide to

2) See E. M. Graham (1996), "Global Corporation and National Governments."
3) See B. Bishop (2001), "Liberalizing Foreign Direct Investment Policies in the APEC Region."
4) See B. Bishop (2001), "Liberalizing Foreign Direct Investment Policies in the APEC Region."

the Secretariat, and shows that some member economies are more diligent than others in providing comprehensive information.

## 4. EVALUATION OF APEC INVESTMENT AGREEMENTS

*MFN Principles*

Bilateral investment treaties use two different standards to prevent discriminatory treatment of different classes of investments, the MFN treatment standard and the national treatment standard. The MFN standard is a core element of international investment agreements, which seeks to prevent discrimination against investors from foreign countries on grounds of their nationality. The MFN standard gives investors a guarantee against certain forms of discrimination by host countries and is crucial for the establishment of equality of competitive opportunities between investors from different foreign countries.

In principle, one can distinguish several types of MFN clauses. They can be either unilateral or reciprocal, conditional or unconditional, limited (by territory, time, or substantive scope) or unlimited. MFN clauses in investment matters are usually reciprocal, unconditional and apply to all investment-related matters. Although MFN clauses are characterized by a basic similarity in terms of structure and substantive coverage, they nevertheless differ in one important area, namely, whether they apply only at the post-entry stage or also at the pre-entry stage. The majority of BITs do not include binding provisions concerning the admission of foreign investment. This means that there is an obligation to apply MFN under these terms only after an investment has been made. With regard to the pre-establishment phase, contracting parties are usually encouraged to create favorable conditions for foreign investors and admit their investments in accordance with their domestic laws. Some BITs, most notably those of the US and Canada and some regional agreements such as NAFTA offer a pre-and post-entry MFN standard.

There are several exceptions to the MFN standard, such as general exceptions (national security reasons), exceptions based on reciprocity considerations (taxation and intellectual property), exceptions related to special privileges accorded to members of a customs union or a free trade area, and individual country-specific exceptions.

The US Prototype as well as NAFTA contains a provision state that MFN applies only to investors and investments that are in “like situations” or in “like circumstances.” Thus, signifying different treatment is justified if they are in different objective situations. The US Prototype Agreement and the US-Vietnam Treaty both state that intellectual property rights concluded under the auspices of the World Intellectual Property Organization do not fall under the MFN provisions.

*National Treatment*

The foundation of a liberalized investment regime is the absence of distinction between domestic and foreign investors. National treatment is the principle whereby a host country extends to foreign investors treatment that is at least as favorable as the treatment that it accords to national investors in like circumstances. While this is an important standard, it is perhaps the most difficult to achieve, as it touches upon politically and economically sensitive issues. The exceptions to national treatment are general exceptions based on reasons of public health, order and morals, and national security. Such exceptions are present in almost all multilateral regional, prototype and bilateral agreements. Subject specific exceptions which exempt specific issues from national treatment, such as intellectual property, taxation provisions in bilateral tax treaties, prudential measures in financial services or temporary macroeconomic safeguards. Country-specific exceptions also whereby a contracting party reserves the right to differentiate between domestic and foreign investors under its laws and regulations – in particular, those related to specific industries or activities – for reasons of national economic and social policy.

The ASEAN model offers a temporary list of national treatment exclusions, reviewed every two years, and to be progressively phased out by 2010 by all Member States, with the exception of late entrants. This is very progressive in the sense that it accounts for national treatment in sectors such as manufacturing, agriculture, fishery, forestry, mining and quarrying, as outlined in the Protocol to Amend the Framework Agreement on the ASEAN Investment Area.

The New-Zealand-Singapore Agreement also has a provision that the Parties undertake to review at least every two years the status of the limitations on national treatment.

*Performance Requirements*

Investors may object to performance requirements because they impede the management of their investment and may require the investor to conduct the business in ways that reduce its efficiency and profitability. It has also been argued that because they regulate imports and exports, certain performance requirements may also distort international trade. According to the provisions outlined in the treaties, they are well followed. However, the Investment Guidebook and IAPs suggests that there are many exceptions to the rule.

*Expropriation and Compensation*

Practically all the agreements examined adopt some variation of the traditional rule of international law that a State may not expropriate the property of an alien except for a public purpose, in a non-discriminatory manner, upon payment of compensation, and in accordance with due process of law. This provision of the NBIP aims at facilitating rather than liberalizing investment. Its inclusion stems from the fact that many investments are long-term and before making such a commitment, foreign investors need to be confident that their property cannot be taken by the state other than for public purposes and then only if prompt adequate and effective compensation is paid to them. The provision adopts the highest international standards with regard to expropriation and compensation.

The expropriation and compensation clauses are well followed according to the bilateral, prototype and regional agreements. The US and Chile prototypes as well as the Canada-Chile BIT and NAFTA contain very detailed provisions in this regard.

It is noteworthy that the Chile-Korea treaty expanded coverage of this provision so that investors affected have the right to prompt access under the law of the contracting party making the expropriation to review the amount of compensation and legality of any such expropriation or comparable measure.

*Repatriation and Convertibility*

The provisions on the transfer of payments are considered by both investors and countries as among the most important in an investment agreement. There are aspects here in which the interests of the host country and the foreign investor may differ widely. The Eminent Person's Group found this provision in the NBIP to be weaker than comparable international standards primarily because it appears to allow member economies to move at their own pace towards totally free movement of capital flows related to foreign investment projects. While most economies in the region have now adopted Article 8 of the IMF provisions related to free movement of capital, many of these economies still have onerous bureaucratic requirements in place and some have not yet adopted freely convertible currency regimes. The repatriation and convertibility provision seeks the removal of these restrictions[5].

Repatriation and convertibility were in most cases well followed. Several agreements stated exceptions to prevent a transfer; those being bankruptcy, insolvency, or the protection of the rights of creditors; issuing, trading or dealing in securities; criminal or penal offenses; ensuring compliance with orders or judgments in ad judicatory proceedings.

*Settlement of Disputes*

Provisions for the settlement of disputes are important as a means of ensuring that the standards of treatment and protection granted by a treaty are effectively implemented and enforced. The presence of effective mechanisms for the resolution of disputes is the ultimate guarantee of protection for foreign investors. The most commonly accepted forum for resolving state-foreign investor disputes is the international arbitration institution established under the International Convention for the Settlement of Investment Disputes (ICSID). The provision also

5) See B. Bishop (2001), "Liberalizing Foreign Direct Investment Policies in the APEC Region."

takes account of traditional East Asian preferences for informal resolution of disputes by specifically requiring consultations and negotiations prior to more formal dispute resolution procedures. The settlement of disputes provisions in the treaties vary greatly in scope and detail among the agreement examined, but do generally follow the NBIPs and menu of options.

*Entry and Sojourn of Personnel*

The efficient operation of an investment may require the application of specialized knowledge possessed only by foreign nationals. For these reasons host countries need to find a reasonable balance between their right to exclude aliens and their desire to provide a favorable investment climate, necessitating the admission of certain aliens. Thus we find in the Investment Guidebook that the provisions related to the stay of foreign personnel are often the most lengthy and complex part of the entry. An examination reveals that each economy has its own system for issuing visas and work permits, with little standardization evident across the region. A precursor to any liberalization may be some degree of policy harmonization.[6] The treaties examined do not all contain provisions providing for the entry and sojourn of personnel. However, those that do, follow the general APEC provisions.

*Avoidance of Double Taxation*

The provisions for the avoidance of double taxation in the APEC instruments is arguably weak in that it appears only to encourage the formation of double taxation agreements rather than attempt to harmonize their provisions. For this reason, ABAC has made a number of recommendations on the issue. However, separate from the APEC provisions, the avoidance of double taxation measures appear to be well followed as most economies have provisions in their bilateral investment treaties dealing separately with double taxation. The Investment Guidebook and IAP entries provide an extensive list of the number of double taxation treaties covered to date in each economy.

*Intellectual Property Rights*

Perhaps due to the "newness" of this issue, its provisions are only found in the more recent treaties like Korea-Japan treaty signed in March 2002. Yet the provisions are very rudimentary as they are lacking in Menu of Options. Nevertheless, this agreement signals the beginning stages of implementation of this measure for future agreements.

*Technology Transfer*

Most BITs do not mention technology as such. However, it is noteworthy that the Menu of Options provisions read as a positive statement outlining parties' duties to reduce

6) See B. Bishop (2001), "Liberalizing Foreign Direct Investment Policies in the APEC Region."

restrictions and provide protection on the transfer of technology. This is an issue that needs further implementation and surveillance.

*Transparency*

Transparency is an important feature of a favorable investment climate. Foreign investors are more likely to invest in a country if they believe that they can ascertain the laws that will govern their investments. The transparency of laws and other government measures has many facets, from simply disclosing and publicizing all government measures in accordance with a country's legal system, to specifically notifying and making available certain types of measures to an international body or to officials of another country. In this respect there are not too many transparency clauses in the agreements examined. However, the Investment Guidebook and IAPs thoroughly cover the transparency provisions of each member economy.

*Business Facilitating Measures*

The Menu of Options entry on business facilitating measures is quite lengthy with13 different points under its heading. Yet not one agreement examined incorporates its provisions in their multilateral, regional, prototype or bilateral treaties. The US-Vietnam agreement has a list of provisions on business facilitation but this list does not correspond to that of the Menu of Options. The Investment Guidebook and IAPs do a better job of incorporating some of these principles in their respective entries.

*Newly Emerging Issues*

The following are newly emerging issues, and there is no mention in the multilateral, regional prototype and bilateral treaties on the topics of start-up companies and venture capital, removal of barriers to capital exports, investment behavior and competition policy.

## 5. CONCLUDING REMARKS

As section VI outlines, there are varying degrees to which different non-binding investment measures are followed. Provisions in areas such as MFN and Settlement of Disputes are extremely well accounted for, whereas issues in Transparency, Performance Requirements, Repatriation and Convertibility and Expropriation and Compensation could be better implemented to match the APEC investment instruments. It is noteworthy that there are a surprising number of areas in which no action has been taken for implementation into the multilateral, regional, prototype and bilateral investment treaties. These are issues in the areas of Competition Policy and Regulatory Reform, Investment Behavior, Start-up companies and Venture Capital. In fairness, it should be noted that some of the under-implemented provisions are included in the Investment Guidebook and IAPs of each APEC economy. However, the test of whether liberalization is truly heeded is if measures are made legally binding under a treaty setting. Despite APEC's efforts to liberalize investment, it appears that harmonization of APEC investment instruments and multilateral, regional, prototype and bilateral treaties have been difficult to achieve due to the economic and political considerations of individual member economies. In fact, even the provisions which have been well implemented contain several exceptions to the general case[7].

When comparing the provisions of the NBIPs and the Menu of Options, it is clear that the Menu items are more detailed. Perhaps due to these characteristics, many of the treaties examined failed to implement most of the measures in the Menu of Options. In areas such as Transparency, Repatriation and Convertibility, Intellectual Property Rights, Technology Transfer, and Business Facilitating Measures to Improve the Domestic Business Environment steps were taken by many treaties to incorporate aspects of the APEC instruments. Thus, these steps partially implement measures rather than fully incorporate all Menu items in their provisions. However, this should not act as a barrier to creating more provisions as more options reflect better ways in which a country can liberalize its investment regime. Indeed, the recently signed treaties of Korea-Japan, and US-Vietnam show that there is a movement in incorporating the newly emerging issues in the investment environment such as intellectual property rights and technology transfer. This momentum should be encouraged as new BITs are negotiated and signed between APEC member economies.

One suggestion for the APEC investment instruments is that it may do well in adding 'subrogation' to its provisions as the vast majority of treaties incorporated this measure into their agreements. The provision typically states if a contracting party makes a payment to its investor under a guarantee it has given in respect of an investment in the territory of the other contracting party, the latter contracting party recognize the assignment of all the rights and claims of the indemnified investor. The addition of this provision in the NBIPs and Menu of Options would aid it to become a more comprehensive list.

If it is difficult for APEC member economies to implement these instruments amongst themselves, then how much more difficult will it be in a multilateral setting with all the various countries bringing their own issues to the negotiating table. Despite this difficulty, it remains a stark fact that global FDI trends are on the rise. The need will arise sooner or later for multilateral rules on investment. APEC members must individually strive towards facilitating this inevitability by improving their investment regimes through regularly updating their IAPs and Investment Guidebooks. APEC members must also collectively

7) Examples include MFN Principles, Performance Requirements and Repatriation and Convertibility, as described in section IV.

endeavor to improve and implement the Collective Action Plans and other joint efforts such as expanding upon the Menu of Options. Only then can the Group take this one step further in providing concrete suggestions and guidelines for a multilateral arena for investment. The ultimate goal is to provide input into the WTO Working Group on the Relationship between Trade and Investment to relay the benefits and challenges of implementing non-binding investment measures. There are many difficult areas in the road ahead, especially with the advent of new issues such as intellectual property rights, technology transfer and start-up companies and venture capital. Yet, if APEC members are successful in proving that liberalization is possible using their investment tools, it can act as a springboard for stimulating a real dialogue and action at the WTO.

# Recent OECD Trends in Foreign Direct Investment

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On behalf of the OECD, I would like to thank the Government of Korea and Invest Korea for hosting this event. Many thanks also to the other members of APEC and representatives from business and academic circles for their interest and participation in this seminar.

I am pleased to say a few words about recent trends in OECD countries' foreign direct investment (FDI) flows. OECD monitors FDI on the basis of regular reporting of detailed flow and stock data by its Member governments. I will report the findings published last July which I understand have been made available to you on paper.

There are 30 members of OECD − including Korea which joined the Organisation in 1996. OECD countries are the source of 70 to 80 per cent of worldwide direct investment flows and home to most of the world's multinational enterprises.

## Starting with recent FDI trends into OECD countries

When we are looking at FDI inflows to OECD countries over the ten or fifteen years or so, the "bad news" is that is that, rising continuously in the 1990's, they have been falling sharply for the last five years − as we can see it the first slide. The good news, however, is they may have begun to bounce back.

Of course, the decline in foreign direct investment since 2000 can be seen as an adjustment to more sustainable levels, following an investment bubble fed by a wave of privatisations, high-tech euphoria, and a flurry of transatlantic and intra-EU mergers and acquisitions in the peak years of 1999 and 2000.

Another sign of this is that at $407 billion in 2004, OECD FDI inflows can not be considered to be particularly low by historical standards.

We obviously have no firm data for 2005 yet. However, quarterly data and private sector data covering mergers and acquisitions suggest that direct investment inflows into the OECD have increased markedly this year, possibly as much as 15 to 20 per cent.

Turning to individual countries (Slide 3), one could argue that the expected gradual turnaround in 2005 is taking place because of the United States and United Kingdom and despite most of the other OECD countries.

US inflows in 2004 stood at 107 billion USD － double the amount in 2003. The United Kingdom FDI tippled in 2004 with a total of $ US 78 billion.

The US and UK cases are somewhat related: part of the story is that a revival of mergers and acquisitions back and forth between the two countries seems to have taken place, and more particularly in the financial sector.

There has been however a sharp decline in inward investment into France and Germany, the two largest European economies. Germany even witnessed a major reversal of flows. This is related to the weak business cycle, the strength of the euro and structural adjustment problems in continental Europe.

However, some caution is called for. Foreign investors did not stop investing in Germany altogether in 2004 － they did bring in fact 22 billion USD of fresh money . However, this amount was dwarfed by an even larger withdrawal of funds held in the German subsidiaries of multinational enterprises in response to changes in the German corporate tax code.

## Now what about recent foreign direct investment out of OECD countries?

The story here is that OECD countries have very active outward direct investors in the last the last couple of years.

Direct investment outflows stood US$ 668 billion in 2004 － one of the highest levels they ever attained apart from the boom years 1999 and 2000. On current indications also suggest they may also increase by a further 10-15 per cent in 2005.

As it can be observed in slide 4, the United States was by far the largest source of outward FDI as US enterprises invested 252 billion USD abroad in 2004 － more than a third of the OECD total.

The UK, France, Canada, Japan have also been consistently active as outward investors in recent years.

Bilateral data indicates that the bulk of this money continues to flow to other OECD countries but an increasing share is directed toward developing and emerging economies. Latin America and Asia has been the main beneficiaries.

## This leads me to the OECD and the rest of the world

With outflows picking up and inflows receding until recently, the OECD area has emerged as a major net outward direct investor toward the rest of the world. (Slide 1 again) Net outflows in 2004 almost doubled from the previous year. They totalled 262 billion USD － their highest level in recorded history.

OECD countries have for a long time been net outward investors, what is different is now is that the amounts are much larger and can be expected to continue to grow.

Which non-OECD countries have been the main beneficiaries? As my colleague from UNCTAD can tell you, there is no doubt that China is by far the largest recipient of FDI outside our member countries. However, it has so far not been the main recipient of direct investment from the OECD. (Slide 4)

That honour goes to Singapore, which a couple of years back had a total inward FDI stock vis-à-vis OECD countries of no less than 103 billion USD. Two economies tied for second place, namely Brazil and Hong Kong-China, both of them with about 70 billion USD in inward position. China came forth with about 40 billion USD – though I must admit that if flows continue at the pace we have seen recently this country will catch up in the not-so-distant future.

Finally, a word of caution to you all and perhaps especially to ourselves in the OECD. It is becoming simplistic to think of the "developing world" as mere targets of outward FDI from the more mature economies. Many of the emerging economies are emerging as outward investors.

One example is China, which in 2000 even launched an official policy of encouraging companies to invest abroad. Companies have heeded the advice, including high-profile investments in minerals and the ICT sectors. Another example is enterprises in the ASEAN countries and several Latin American countries who have engaged in regional expansion strategies by means of investment and appear ready to embark on even more global strategies.

The conclusion that can be drawn from this is, the world is no longer divided in "home" and "host" countries. Countries at all levels of economic development increasingly face the same investment policy challenges. Challenges that they need to address jointly and in cooperation with each other. APEC is a wonderful -forum for such cooperation.

This seminar is a very timely one and I look very much forward to the discussions we will be having.

Thank you very much.

**APEC-OECD SEMINAR**

**"Working Together on Investment for Development"**

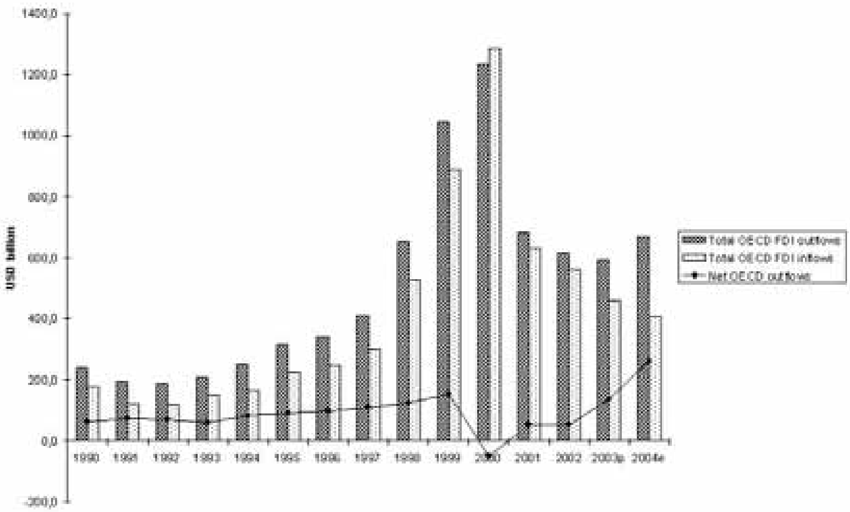
Recent OECD trends

in Foreign Direct Investment

Presentation by Marie-France Houde

OECD Investment Division.

FDI Flows to and from OECD




Source OECD International Direct Investment database

OECD 2 OCDE

## Inward FDI in selected countries (US$ bn.)

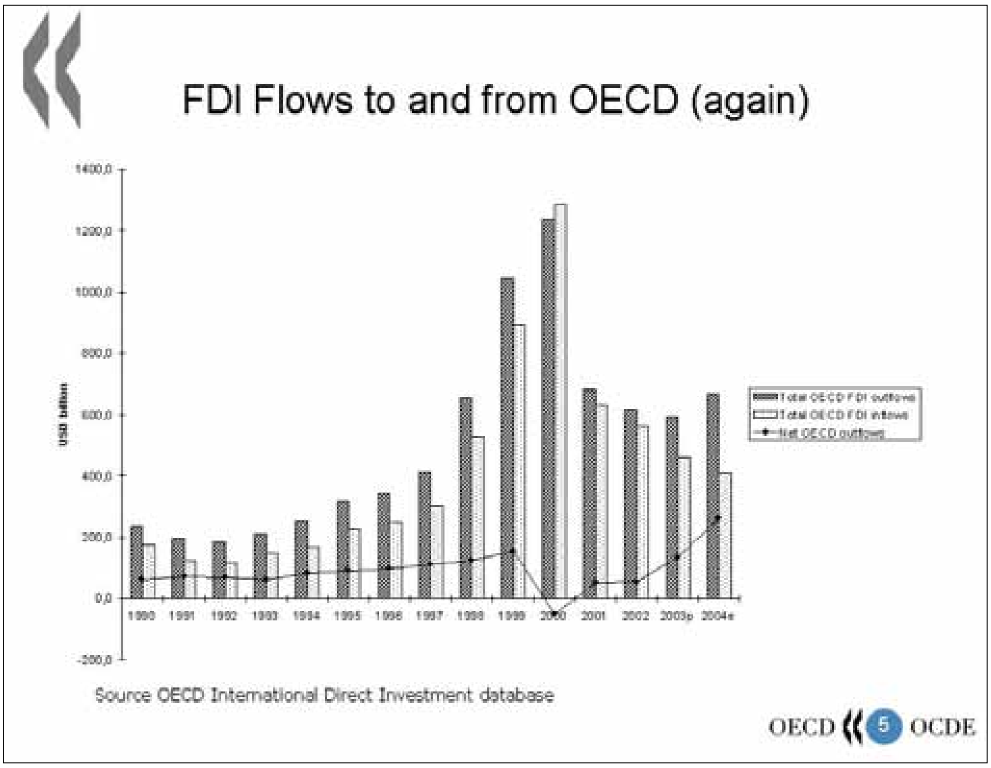
| | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| OECD total | 632 | 562 | 459 | 407 |
| Of which: | | | | |
| U.S. | 167 | 81 | 67 | 107 |
| U.K | 53 | 24 | 20 | 79 |
| Germany | 26 | 51 | 27 | -39 |
| France | 51 | 49 | 43 | 24 |
| Japan | 6 | 9 | 6 | 8 |

OECD 3 OCDE

## Outward FDI from selected countries (US$ bn.)

| | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| OECD total | 684 | 615 | 593 | 668 |
| Of which: | | | | |
| U.S. | 142 | 155 | 141 | 252 |
| U.K | 59 | 50 | 67 | 65 |
| Germany | 40 | 15 | -4 | -7 |
| France | 87 | 51 | 53 | 48 |
| Japan | 38 | 32 | 29 | 31 |

OECD 4 OCDE


FDI Flows to and from OECD (again)
1400,0
1200,0
1000,0
800,0
600,0
400,0
200,0
0,0
-200,0
USD billion
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003p 2004e
Total OECD FDI outflows
Total OECD FDI inflows
Net OECD outflows
Source OECD International Direct Investment database
OECD 5 OCDE

# Global Trends in FDI Towards a Wider Role for Developing Countries[1)]

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## Abstract

Global trends in foreign direct investment (FDI) suggest a growing role of developing countries, in several ways. First, the share of world FDI going to developing countries continued to rise in 2004, reaching 36%. While inflows to the developed world declined by another 14%, inflows to developing countries surged by 40%. Second, a number of developing countries are emerging as significant sources of FDI. Third, transnational corporations locate even highly strategic corporate functions, such as research and development (R&D), in selected developing countries. More importantly, some of the R&D activities being established especially in Asia are highly innovative and sophisticated in nature, extending beyond R&D undertaken purely to adapt products and services to the local market. The paper concludes by noting that policy developments also reflect the growing importance of developing countries as both hosts and home countries. The paper further argues that active and coherent policies are essential to ensure that a country benefits from the process of R&D globalization.

## 1. Resumed growth in global FDI led by developing countries

Foreign direct investment (FDI) accounts since some years for the largest share of external capital flows to developing countries. It is an important complement to domestic capital formation as well as to other forms of external capital transfers. From a development perspective, FDI offers potential benefits not only through the transfer of capital, but also of knowledge and technology, by enhancing access to sources of supply as well as markets, and by spurring competition and productivity gains. In 2004, FDI accounted for more than half of all financial resource flows to developing countries and was considerably larger than official development assistance (ODA). However, the bulk of FDI to developing countries goes to a handful of countries and ODA remains the most important source of finance in a number of other developing countries, notably the least

1) This paper draws heavily on the World Investment Report 2005: Transnational Corporations and the Internationalization of R&D (WIR05). Unless otherwise stated, WIR05 is the source of the information.

developed ones.

After three years of declining flows of foreign direct investment (FDI), a sharp increase in the inflows to developing countries led to a slight rebound in 2004 (UNCTAD, 2005a). At $648 billion, world FDI inflows were 2% higher than in 2003. Inflows to developing countries surged by 40%, to $233 billion, while developed countries as a group experienced a further 14% drop. As a result, the share of developing countries in world FDI inflows reached 36% (table 1) — the highest level since 1997.

Various factors help to explain why the growth of FDI was particularly pronounced in developing countries. Intense competitive pressures in many industries are forcing firms to explore new ways of improving their competitiveness. Some of these ways are by expanding operations in the fast-growing markets of emerging economies to boost sales, and by rationalizing production activities with a view to reaping economies of scale and lowering production costs. The slow-down in the world economy after the collapse of the dot-com bubble accentuated the pressure on firms and spurred even more restructuring: in manufacturing as well as services. Indeed, facilitated by improvements in information and communication technology, various business services (such as call centres, back-office functions and IT services) have increasingly been offshored to achieve cost savings or improve the quality of the service produced (UNCTAD, 2004).

**Table 1. FDI flows, by region and selected countries, 1993-2004**
**(Billions of dollars)**

| Region/country | FDI inflows | | | | | | | FDI outflows | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1993-1998 (Annual average) | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 1993-1998 (Annual average) | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| Developed economies | 256.2 | 849.1 | 1 134.3 | 596.3 | 547.8 | 442.2 | 380.0 | 353.3 | 1 014.1 | 1 092.7 | 662.2 | 599.9 | 577.3 | 637.4 |
| Europe | 147.3 | 520.4 | 722.8 | 393.9 | 427.6 | 359.4 | 223.4 | 218.1 | 763.5 | 866.1 | 451.3 | 396.9 | 390.0 | 309.5 |
| European Union | 140.3 | 501.5 | 696.3 | 382.6 | 420.4 | 338.7 | 216.4 | 200.8 | 724.6 | 813.4 | 433.9 | 384.5 | 372.4 | 279.8 |
| United States | 86.1 | 283.4 | 314.0 | 159.5 | 71.3 | 56.8 | 95.9 | 92.3 | 209.4 | 142.6 | 124.9 | 134.9 | 119.4 | 229.3 |
| Japan | 1.3 | 12.7 | 8.3 | 6.2 | 9.2 | 6.3 | 7.8 | 21.4 | 22.7 | 31.6 | 38.3 | 32.3 | 28.8 | 31.0 |
| Other developed countries | 21.5 | 32.5 | 89.2 | 36.7 | 39.6 | 19.6 | 52.9 | 21.5 | 18.5 | 52.5 | 47.7 | 35.8 | 39.1 | 67.6 |
| Developing economies | 138.9 | 232.5 | 253.2 | 217.8 | 155.5 | 166.3 | 233.2 | 56.6 | 88.2 | 143.2 | 78.6 | 47.8 | 29.0 | 83.2 |
| Africa | 7.1 | 11.9 | 9.6 | 20.0 | 13.0 | 18.0 | 18.1 | 2.3 | 2.5 | 1.6 | - 2.6 | 0.4 | 1.2 | 2.8 |
| Latin America and the Caribbean | 47.9 | 108.6 | 97.5 | 89.1 | 50.5 | 46.9 | 67.5 | 12.7 | 44.7 | 60.6 | 29.1 | 11.4 | 10.6 | 10.9 |
| Asia and Oceania | 83.9 | 112.0 | 146.0 | 108.7 | 92.0 | 101.4 | 147.6 | 41.6 | 41.0 | 81.1 | 52.0 | 36.0 | 17.2 | 69.4 |
| Asia | 83.4 | 111.6 | 145.7 | 108.6 | 92.0 | 101.3 | 147.5 | 41.6 | 41.1 | 81.1 | 52.0 | 36.0 | 17.2 | 69.4 |
| West Asia | 3.5 | 1.9 | 3.8 | 7.1 | 5.7 | 6.5 | 9.8 | 0.2 | 1.6 | 1.4 | 1.1 | 0.9 | - 4.0 | 0.0 |
| East Asia | 51.6 | 77.3 | 116.2 | 78.7 | 67.3 | 72.1 | 105.0 | 31.7 | 29.8 | 72.0 | 26.1 | 27.6 | 14.4 | 53.5 |
| China | 38.5 | 40.3 | 40.7 | 46.9 | 52.7 | 53.5 | 60.6 | 2.6 | 1.8 | 0.9 | 6.9 | 2.5 | - 0.2 | 1.8 |
| South Asia | 2.9 | 3.1 | 3.1 | 4.1 | 4.5 | 5.3 | 7.0 | 0.1 | 0.1 | 0.5 | 1.4 | 1.1 | 1.0 | 2.3 |
| South-East Asia | 25.3 | 29.3 | 22.6 | 18.8 | 14.5 | 17.4 | 25.7 | 9.6 | 9.6 | 7.2 | 23.3 | 6.4 | 5.8 | 13.6 |
| Oceania | 0.4 | 0.4 | 0.3 | 0.1 | 0.0 | 0.1 | 0.1 | 0.0 | - 0.1 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| South-East Europe and the CIS | 6.6 | 10.5 | 9.1 | 11.8 | 12.8 | 24.1 | 34.9 | 1.3 | 2.6 | 3.2 | 2.7 | 4.5 | 10.6 | 9.7 |
| South-East Europe | 1.6 | 3.7 | 3.6 | 4.5 | 3.8 | 8.4 | 10.8 | 0.1 | 0.1 | 0.0 | 0.2 | 0.6 | 0.1 | 0.2 |
| CIS | 5.0 | 6.8 | 5.5 | 7.3 | 9.0 | 15.7 | 24.1 | 1.3 | 2.5 | 3.2 | 2.5 | 3.9 | 10.4 | 9.5 |
| World | 401.7 | 1 092.1 | 1 396.5 | 825.9 | 716.1 | 632.6 | 648.1 | 411.2 | 1 104.9 | 1 239.1 | 743.5 | 652.2 | 616.9 | 730.3 |
| *Memorandum: share in world FDI flows* | | | | | | | | | | | | | | |
| Developed economies | 63.8 | 77.7 | 81.2 | 72.2 | 76.5 | 69.9 | 58.6 | 85.9 | 91.8 | 88.2 | 89.1 | 92.0 | 93.6 | 87.3 |
| Developing economies | 34.6 | 21.3 | 18.1 | 26.4 | 21.7 | 26.3 | 36.0 | 13.8 | 8.0 | 11.6 | 10.6 | 7.3 | 4.7 | 11.4 |
| South-East Europe and the CIS | 1.6 | 1.0 | 0.6 | 1.4 | 1.8 | 3.8 | 5.4 | 0.3 | 0.2 | 0.3 | 0.4 | 0.7 | 1.7 | 1.3 |

Source: UNCTAD, *World Investment Report 2005: Transnational Corporations and the Internationalization of R&D*, annex table B.1.

Some FDI expansion in developing countries that are rich in natural resources was also triggered by rising prices for commodities such as oil and minerals. In selected developing (and developed) countries, increased inflows in 2004 were furthermore linked to an upturn in cross-border merger and acquisition (M&A) activity.[2)]

While FDI fell in the developed countries as a group, inflows to the United States surged to $96 billion, making it the top recipient in 2004 ahead of the United Kingdom and China. FDI into Japan rose by 24% to $8 billion. The EU-25 as a whole recorded yet another weak year as inflows dropped to $216 billion — the lowest level since 1998. However, there were notable differences between the "old" EU-15, where investment flows plummeted by 40%, and the 10 new EU members, which all saw notable increases.

Among the developing regions, Asia and Oceania remained the top destination of FDI. It attracted $148 billion of FDI, $46 billion more than in 2003, marking the largest ever increase. East Asia saw a 46% increase in inflows to $105 billion, driven largely by a significant increase in flows to Hong Kong (China). China continued to be the largest developing-country recipient with $61 billion in FDI inflows. In South-East Asia, FDI surged by 48% to $26 billion, while South Asia, with India at the forefront, received $7 billion, a 30% rise. FDI inflows to West Asia grew from $6.5 billion to $10 billion, of which more than half was concentrated in Saudi Arabia, the Syrian Arab Republic and Turkey.

Following four years of continuous decline, FDI flows to Latin America and the Caribbean registered a significant upswing in 2004, reaching $68 billion — 44% above the level attained in 2003. Economic recovery in the region, stronger growth in the world economy and higher commodity prices were contributing factors. Brazil and Mexico were the largest recipients, with inflows of $18 billion and $17 billion respectively. Together with Chile and Argentina they accounted for two-thirds of all FDI flows into the region in 2004. Meanwhile, there were notable declines in Bolivia and Venezuela, mainly linked to uncertainty regarding legislation in the area of oil and gas production. A number of countries modified their legislation and tax regimes to increase the State's share in revenues from non-renewable natural resources. It is still too early to assess the impact of these changes on the volume of FDI.

FDI flows to Africa remained at almost the same level — $18 billion — as in 2003. Despite these developments Africa's share in FDI flows worldwide remains low at 3%. FDI in natural resources was particularly strong, reflecting the high prices of minerals and oil and the increased profitability of investment in the primary sector. High and rising prices of petroleum, metals and minerals induced TNCs to maintain relatively high levels of investment in new exploration projects or to escalate existing production. Angola, Equatorial Guinea, Nigeria, Sudan (all rich in natural resources) and Egypt were the largest

2) For example, the largest M&A deal in the developing country in 2004, the takeover of the beverages firm Braco (Brazil) by Interbrew (Belgium), was valued at some $4 billion (UNCTAD, 2005a, p. 255).

recipients, accounting for a little less than half of all FDI into that continent. LDCs in Africa received small amounts: around $9 billion in total. Most investment in Africa originated from Europe, led by investors from France, the Netherlands and the United Kingdom, and from South Africa and the United States; together these countries were responsible for more than half of the region's inflows.

A renewed wave of FDI-friendly measures and initiatives at national and international levels has sought to facilitate and attract more FDI to the African continent. At the national level, many measures focused on liberalizing legal frameworks and improving the overall environment for FDI. However, failure to move rapidly on economic and social policies important for attracting and retaining FDI, and weak emphasis on capacity building, have hampered the ability of many countries in the region to attract FDI, in particular in manufacturing. Thus far, international market-access measures and initiatives targeting African countries (such as the United States' African Growth and Opportunity Act) overall have not been very successful in increasing FDI. In order to realize the potential for increased FDI and to derive greater benefits from it, African countries generally need to develop stronger industrial and technological capabilities.

FDI inflows to South-East Europe and the Commonwealth of Independent States (CIS), a new subgroup of economies under the United Nations classification, recorded a fourth year of growth in 2004, reaching an all-time high of $35 billion. The Russian Federation is the largest recipient of FDI inflows in the region. In South-East Europe, FDI inflows started to grow only in 2003. Led by large privatization deals, these inflows nearly tripled, to $11 billion in 2004. In the CIS, inflows grew from $5 billion in 2000 to $24 billion in 2004, benefiting largely from the high prices of petroleum and natural gas.

*More FDI in the cards*

UNCTAD estimates that the small growth in global FDI flows witnessed in 2004 will gain momentum in 2005 and 2006; this time also extending to developed countries as a group. The continued need of firms to improve their competitiveness by expanding into new markets, reducing costs and accessing natural resources and strategic assets abroad provides strong incentives for further FDI in developing countries in particular. Improved profitability of TNCs is likely to trigger heightened M&A activity should push up the levels of FDI also in developed countries.

Various surveys undertaken by UNCTAD and others corroborate this picture. In the UNCTAD surveys, more than half of the responding TNCs expected short-term (2005-2006) growth in FDI flows; very few predicted a decline of FDI in the near future. The competitive pressure on firms, continued offshoring of services, ongoing liberalization and the growth of TNCs from emerging markets were identified as factors that should lead to more FDI.

At the same time, there are grounds for caution. The slowdown of growth in some developed countries, along with structural weaknesses and financial and corporate vulnerabilities in some regions, continue to hinder a strong recovery of FDI growth. Continuing external imbalances in many countries and sharp exchange-rate fluctuations, as well as high and volatile commodity prices pose risks that may also dampen the willingness to expand internationally.

There is some variation in the FDI prospects of individual regions. In view of the improved economic situation in Asia and Oceania, its important role as a global production centre, its evolving policy environment and significant regional integration efforts, the prospects for FDI flows to that region are particularly promising. FDI inflows to Latin America and the Caribbean are expected to increase as most of the driving forces behind FDI growth in 2004 are set to remain important. FDI should increase in Africa as well, partly as a result of higher commodity prices and the continent's abundance of natural resources.

## 2. New sources of FDI are emerging

The bulk of FDI originates in developed countries. In fact, even in 2004, as much as 87% of all outflows were linked to investments by firms based in developed countries. Similarly among the top 100 TNCs, 96 are based in developed countries. However, there is a clear trend of rising FDI from the South. In 2004, the total value of outward FDI from developing countries reached $83 billion — the second highest level ever. Accounting for 7% of the world FDI outward stock in 1990, their share rose to almost 11% in 2004 ($1.0 trillion).

The evolution in the share of developing countries in outward FDI should be seen against the backdrop of substantial outflows from developed countries, in particular through M&As which account for a substantial share of the volume of FDI. In addition, if viewed in terms of their outward FDI flows in relation to gross fixed capital formation, a number of developing economies (Singapore, Hong Kong (China), Taiwan Province of China, Chile or Malaysia) show higher ratios than some developed economies (Germany, Japan and — except for Malaysia — the United States) (UNCTAD, 2005b).

The fastest growth in outward FDI has been noted for South, East and South-East Asia: the share of this region in the world outward FDI stock rose from 2.3% to 7.4% between 1990 and 2003. In 2004 the region's outflows quadrupled to $69 billion, due mainly to dramatic growth in FDI from Hong Kong (China) but also to increased investments by TNCs from other parts of the region. Most of these investments are intra-regional, taking place especially among the economies of East and South-East Asia. However, inter-regional investment from Asian economies also increased. For example, a key driver of Chinese outward FDI was the growing demand for natural resources, not least in Latin America. Indian TNCs also invested sizeable amounts in natural resources in other regions, primarily in Africa and in the Russian Federation. Asian investment in developed countries is on the rise as well: the past year in particular has seen a few major acquisitions of United States and EU firms by Indian and Chinese TNCs — such as the acquisition by Lenovo (China) of the personal computers division of IBM (United States).

Latin American firms are still relatively small outward investors. The outward FDI stock of Latin America and the Caribbean reached $272 billion in 2004, representing an increase by 29% since 2000. A large part (46%) of this stock was held by firms registered in offshore financial centres, such as Bermuda, the British Virgin Islands and the Cayman Islands. The main other LAC source countries are Argentina, Brazil, Chile, Mexico, Panama and Venezuela. In light of the size of their economies, the level of outward FDI is relatively low, but efforts have been made to create a conducive environment for further outward expansion, including through the conclusion of a number of international agreements with other developing countries. In 2004, FDI outflows from Latin America and the Caribbean grew modestly to $11 billion, of which as much as $9.5 billion originated from Brazil.

Africa has a relatively small stock of outward FDI, concentrated in five countries: South Africa, Nigeria, the Libyan Arab Jamahiriya, Liberia and Botswana (in that order). These five countries together accounted for about 86% of Africa's outward stock of $46 billion in 2004. South Africa is by far the most important African source of FDI. While almost all of its FDI stock is in developed countries, investment in other neighbouring African countries has recently increased, mainly targeting natural resources and basic industries. In October 2004, the Government of South Africa took further steps to facilitate outward FDI by abolishing exchange control limits on such flows. Four of the top 50 TNCs from the South are South African (UNCTAD, 2005a). FDI outflows from Africa more than doubled in 2004 to $2.8 billion.

It is likely that developing country firms will become more important international players in the coming years. Against this background, the *WIR06* will analyze the emergence of TNCs from the South in more detail to explore possible implications for development and for policy formulation.

## 3. R&D by TNCs goes global

In the *World Investment Report 2004: The Shift Towards Services*, UNCTAD highlighted that services are assuming growing importance in FDI. One illustration of this is the fact that not only manufacturing activities are becoming increasingly fragmented internationally. Services are also part of this process. The "offshoring of services" phenomenon is still at a relatively early stage, but it is expected to pick up speed over time as there are important cost advantages from specializing service functions and from allocating work to locations where the services can be more efficiently produced.

An interesting finding in *WIR04* was that virtually all service functions are potential targets for offshoring activities. A survey by UNCTAD and Roland Berger Strategy Consultants (2004) of Europe's largest firms conducted in 2004 showed that there are no "sacred cows". While about 80% of companies mentioned at least one service activity that they would not consider for offshoring, *no business process* was explicitly excluded from offshoring considerations by more than 20% of the respondents. In fact, even the most strategic function of all — research and development (R&D) — is part of this process.

Until recently, R&D internationalization was confined to the developed countries. Today, TNCs in industries like automotive, electronics, biotechnology and pharmaceuticals are establishing R&D facilities in selected parts of the developing world. They do this to enhance their efficiency, to access expanding pools of talent and to meet the demands from increasingly sophisticated market places in these countries. As noted in the preface to the *WIR05* by the Secretary-General of the United Nations, these trends have important implications for the international division of labour: "*Firms now view parts of the developing world as key sources not only of cheap labour, but of growth, talent and even new technology.*"

In terms of creating new technology and diffusing it internationally, TNCs are the world leaders. They account for the bulk of world business expenditures on R&D. For example, six TNCs (Ford, Pfizer, DaimlerChrysler, Siemens, Toyota and General Motors) spent more than $5 billion on R&D in 2003. By comparison, only Brazil, China, the Republic of Korea and Taiwan Province of China had larger R&D expenditures among developing economies. TNCs dominate new patent registrations and often lead innovation in management and organization. As TNCs are the dominant players in the creation of new technology, it matters where they undertake their R&D.

Innovative activity is essential for economic growth and development. Moreover, sustainable economic development requires more than simply "opening up" and waiting for new technologies to flow in. It demands continuous technological effort by domestic enterprises, along with supportive government policies. With the increasing knowledge-intensity of production, the need to develop technological capabilities is growing. Greater openness to trade and capital flows does not reduce the imperative of local technological effort. On the contrary, liberalization, and the open market environment associated with it, have made it necessary for firms — be they large or small, in developed or developing countries — to acquire the technological and innovative capabilities needed to become or stay competitive.

R&D is only one source of innovation, but it is an important one. It takes various forms: basic research, applied research and product and process development. While basic research is mainly undertaken by the public sector, the other two forms are central to the competitiveness of many firms. In the early stages of technological activity enterprises do not need formal R&D departments. As they mature, however, they find it increasingly important to monitor, import and implement new technologies. The role of formal R&D grows as a firm attempts significant technological improvements and tackles product or process innovation. For complex and fast-moving technologies it is an essential part of the technological learning process.

No single country can produce all the knowledge needed to stay competitive and to grow in a sustained manner. Countries are therefore eager to connect with international networks of innovation. Outward and inward FDI in R&D are two ways of doing so. R&D internationalization opens up new opportunities for developing countries to access technology, build high-value-added products and services, develop new skills and foster a culture of innovation through spillovers to local firms and institutions. FDI in R&D can help countries strengthen their innovation systems and upgrade industrially and technologically, enabling them to perform more demanding functions, handle more advanced equipment and make more complex products.

Corporate strategies in this field are changing rapidly. Not only is more R&D conducted outside the home country, TNCs are increasingly bringing in selected emerging market economies into their R&D networks. A few illustrative examples (see also table 2):

- More than half of the world's top R&D spenders already have an R&D presence in China, India or Singapore.
- The number of foreign-owned R&D centres in China increased from zero in the early 1990s to more than 700 today.
- From practically nothing in the mid-1990s, East Asia's contribution to semiconductor design reached almost 30% in 2002.
- STMicroelectronics has some of its semiconductor design done in Rabat, Morocco.
- General Motors (GM) in Brazil competes with other GM affiliates in the United States, Europe and Asia for the right to design and build new vehicles and carry out other core activities for the global company.

Currently, only a few developing countries are attracting R&D on a significant scale. But for those that do, a new door has opened into the TNC networks of knowledge creation, with potential benefits to their development process. Most low-income countries are not participating in these R&D networks and risk becoming increasingly marginalized. Thus, R&D internationalization may lead to both a narrowing and a widening of the technology gap between countries.

This new internationalization of R&D is both expected and unexpected. It is expected for two reasons. First, as TNCs increase their production in developing countries, some R&D is bound to follow. Second, like other services R&D is "fragmenting", with different activities being performed in different locations, depending on the advantages of each location. It is unexpected in that R&D is a service activity with very demanding skill,

**Table 2. Selected R&D centres in emerging markets**

| Company | Location | Features |
|---|---|---|
| General Motors (US) | Brazil | Some 1,000 technical employees are involved in product development, and some 500 in process engineering. |
| Microsoft (US) | China | Two centres (Beijing and Shanghai). Microsoft Research Asia employs over 170 researchers and is the company's fifth largest research centre. |
| Nokia (Finland) | China | Centres in Beijing, Shanghai and Hangzhou, employing more than 500 people. |
| Astra-Zeneca (UK) | India | The company's Research Centre of Excellence in Bangalore focuses on the discovery of new treatments for tuberculosis (TB) and other diseases found in the developing world. More than 100 researchers work at the site. |
| General Electric (US) | India | GE's John F Welch Technology Center, with an investment of $80 million and 1,600 employees, is the company's largest R&D centre outside the United States. GE in India performs R&D related to aircraft engines, white goods and medical equipment. |
| ST Microelectronics (Netherlands) | Morocco | Has located parts of its design activities in Rabat to develop systems on chip products for digital TV, DVD players and flat screen displays. Employs 170 people. |
| Siemens (Germany) | Rep. of Korea | Is investing $119 million in the country over the next 5 years inter alia to develop products for the world market. |
| Philips (Netherlands) | Singapore | Philips Innovation Campus is the firm's largest R&D centre outside Europe with more than 1,000 engineers. |
| Toyota (Japan) | Thailand | Fourth overseas R&D centre. It has a regional mandate for Asia (excl. China) and a global mandate to carry out R&D for the parent company. |

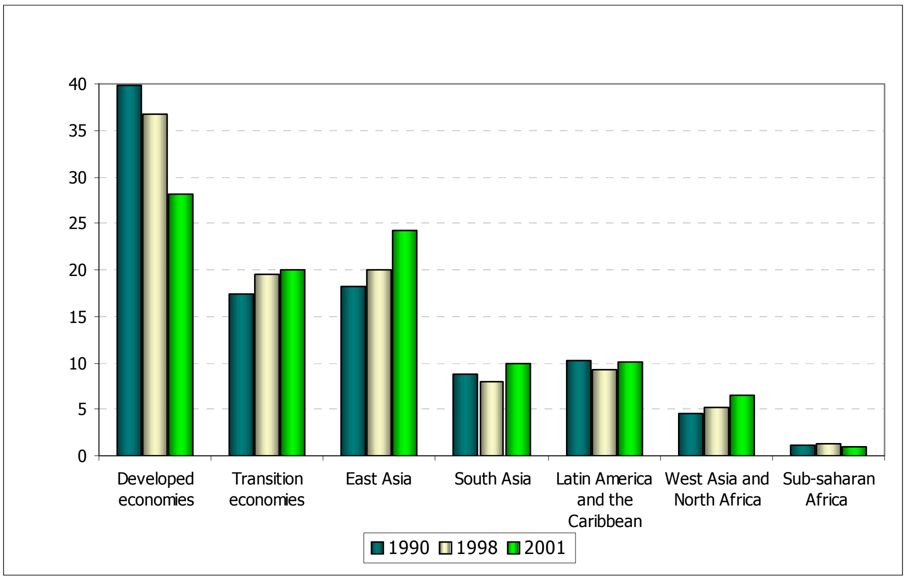
*Source:* UNCTAD.

knowledge and support needs, traditionally met only in developed countries with strong national innovation systems. Moreover, R&D has traditionally been taken to be one the least "fragmentable" economic activities because it involves knowledge that is strategic to firms, and because it often requires dense knowledge exchange between users and producers within localized clusters. So why is it happening?

Companies have long needed a foreign R&D presence to adapt products and processes to local markets (in both developed and developing countries), or to tap leading centres of technological excellence (notably in developed countries). The recent surge of R&D by TNCs in selected developing host economies is unlike earlier patterns. For the first time, developing countries are attracting R&D that is not only aimed at supporting local sales but global operations. The process is driven by a complex interaction of push and pull factors.

On the *push side*, intense competition is forcing companies to innovate more, while keeping their costs down. A combination of increased complexity of R&D work, rising costs and an insufficient number of certain engineering and scientific manpower in industrialized countries compel firms to explore new sources of low-cost and highly qualified researchers. On the *pull side* are a greatly improved availability of scientific and engineering skills at competitive costs, the continuing globalization of manufacturing

**Figure 1. Shares of global technical tertiary enrolments**
(Percent of total)




Source: UNCTAD, WIR05, box figure V.2.2.

Note: Transition economies here comprise South East Europe and the Commonwealth of Independent States as well as the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

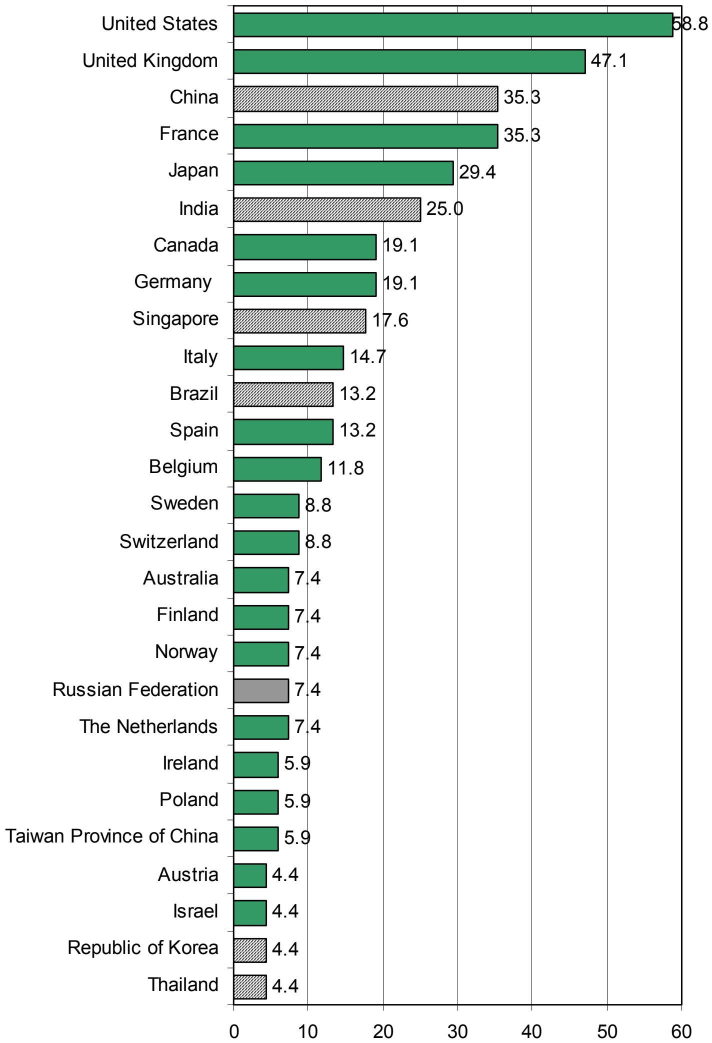
activities, and fast growth in some key emerging markets.

The expanding pool of talent in selected developing countries and economies in transition is particularly important, especially for companies that fail to find a sufficient number of skilled human resources in their home countries. The global supply of skilled people has increased rapidly thanks to a dramatic rise in the number of students enrolled in higher education outside the developed world (figure 1). At the turn of the century, China, India and Russia together accounted for almost a third of all tertiary technical students in the world. In addition, more scientists and engineers working abroad are returning to China and India to perform R&D work for foreign affiliates or local firms. In Bangalore, for example, some 35,000 non-resident Indians have lately returned with training and work experience from the United States. Reflecting the growing competition for the best brains, both developed and developing countries are adopting new measures to attract foreign skills.

A survey of the world's largest R&D spenders conducted by UNCTAD during 2004-2005 also shows the growing importance of new R&D locations. More than half of the TNCs surveyed already have an R&D presence in China, India or Singapore. In South-East Europe and the CIS, the Russian Federation was the only significant target economy mentioned by the responding firms as hosting R&D activities (figure 2).

In the same survey, as many as 69% of the firms stated that the share of foreign R&D was set to increase; only 2% indicated the opposite, while the remaining 29% expected the

**Figure 2. Current foreign locations of R&D in th UNCTAD survey, 2004**
(Percentage of respondents)



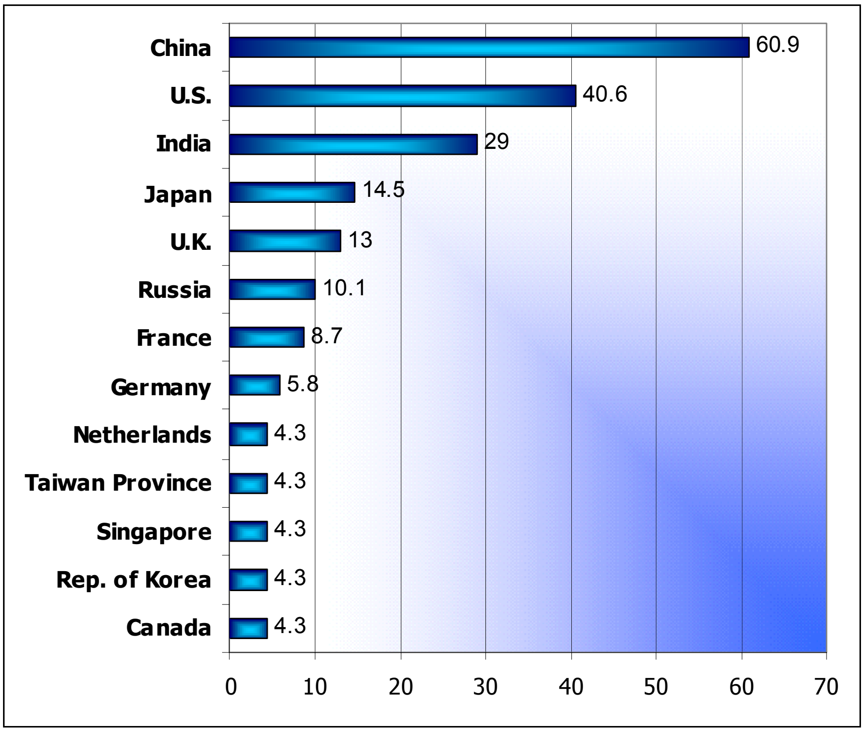

Source: UNCTAD, World Investment Report 2005: Transnational Corporations and the Internationalization of R&D, figure IV. 8.

level of internationalization to remain unchanged. The momentum appears to be particularly strong among companies based in Japan and the Republic of Korea, which until recently have been internationalizing their R&D to a very limited extent.3) A further shift of R&D activities towards some developing, South- East European and CIS markets is also envisaged (figure 3). China is the destination mentioned by the largest number of respondents for future R&D expansion, followed by the United States. In third place is India, another significant newcomer location for R&D. Other developing economies mentioned as candidates for further R&D by some respondents include the Republic of Korea, Singapore, Taiwan Province of China, Thailand and Viet Nam. Very few respondents

3) For example, nine out of ten Japanese companies in the sample planned to increase their foreign R&D, while 61% of European firms stated such intentions.

indicated any plans to expand R&D to Latin America or Africa. The Russian Federation was also among the top 10 target locations.

**Figure 3. Top destinations for future R&D expansion**
(Percentage of respondents)




Source: UNCTAD survey of top R&D spenders, WIR05, figure IV.11.

As noted above, benefits to a host country from inward FDI can be substantial, but they do not appear automatically, and unwanted effects can also arise. The main concerns in economies hosting FDI in R&D relate to the potential downsizing of existing R&D when FDI involves takeovers of domestic firms, unfair compensation to local firms and institutions collaborating with TNCs in the area of R&D, the crowding out of local firms from the market for researchers, a race to the bottom in attracting R&D-related FDI and unethical behaviour by TNCs. There may be tension between TNCs and host-country governments, in that the former may seek to retain proprietary knowledge while the latter seek to secure as many spillovers as possible.

A key determinant of the development impact on a host economy is its absorptive capacity. Other determinants are the type of R&D conducted, and whether the R&D is linked to production. The more a TNC interacts with a host developing country's local firms and R&D institutions, and the more advanced the country's national innovation system (NIS), the greater the likelihood of positive effects on a host economy. R&D internationalization also has implications for home countries — both developed and developing. It can help a country's TNCs improve their competitiveness by accessing strategic assets and new technologies, acquiring unique knowledge at competitive prices, increasing specialization in their R&D, reducing costs, increasing flexibility and expanding their market shares. By extension, the improved competitiveness of TNCs often has positive impacts on their home economies. Foreign R&D can generate opportunities and spillovers in the home economy to the benefit of local firms and the home economy as a whole.

But the transnational expansion of R&D may also give rise to concerns in home countries, especially with regard to the risk of hollowing out and the loss of jobs. These concerns resemble those voiced in connection with the general debate on services offshoring (UNCTAD, 2004). The trend is so new that any assessment must be tentative. However, it does seem that protectionist measures to limit the expansion of R&D abroad will not effectively address these concerns as they would risk undermining the competitiveness of the country's enterprises. Rather, to turn the internationalization process into a win-win situation for host and home countries alike, policies aimed at advancing the specific innovation capabilities and the functioning of the NIS are key.

## 4. Policy implications

The evolving role of developing countries in the international restructuring by TNCs is reflected also in policy developments.

Overall, countries are continuing to adopt measures intended to improve their investment climates. In 2004, UNCTAD's survey of changes in national laws showed that both the number of national policy measures affecting FDI and TNCs that were introduced and the number of economies involved in the process increased. A total of 271 new measures were adopted by 102 economies. The vast majority of regulatory changes tended to make conditions more favourable for foreign companies to enter and operate. Most of these measures implied further liberalization of investment regimes. In terms of regional distribution, Asia and Oceania accounted for 30% of the new measures, followed by the transition economies (22%), Africa (21%), developed countries (14%) and Latin America and the Caribbean (13%).

The patterns varied somewhat by region. In Latin America and the Caribbean, as many as 24% of all changes were unfavourable, and the share was also relatively high in Africa (19%). In terms of their nature, 11 involved less promotional efforts (e.g. making incentives less generous), 9 involved new restrictions to FDI entry and establishment, while 5 affected the operations of foreign investors. The high incidence of such measures may reflect a growing realization in parts of the developing world that liberalization and promotion must be geared more specifically to countries' development objectives.

Developing countries are also increasingly active in terms of entering into various bilateral agreements related to international investment. This likely reflects the growing role of developing countries as both homes and hosts of FDI. The number of bilateral investment treaties (BITs) worldwide continued to expand in 2004, but at a slower pace than before. The largest number (38%) of the new BITs signed during 2004 was among developing countries. In terms of "South-South BITs", China, Egypt, the Republic of Korea and Malaysia have each signed more than 40 treaties with other developing countries. In fact, each of these four countries has signed more agreements with other developing countries than with developed countries.

The expansion of FDI from the South has led more developed countries to pay increased attention to selected developing countries as potential sources of investment. For example, investment promotion agencies (IPAs) in Denmark, Sweden and the United Kingdom have already established a presence in China. IPAs in developing countries could also take advantage of this trend by tailoring promotion and targeting strategies to encourage FDI from the South. In this context, measures that lower the cost of entry could make it easier in developing countries to invest in other developing countries (UNCTAD, 2005b).

As developing countries begin to attract R&D by TNCs, a number of policy and institutional areas need to be addressed by both host and home countries. For potential host countries, the starting point is to build an institutional framework that fosters innovation. Particular policy attention is needed in four areas: human resources, public research capabilities, IPR protection and competition policy. Efforts in these areas need to reflect the comparative advantage and technological specialization of each country as well as the development trajectory along which a country plans to move. FDI policy is also vital to promote the desired forms and impacts of FDI. Selective policies in this area can include targeted investment promotion, performance requirements and incentives along with the use of science and technology parks. Finally governments need to pay attention to more focused policies aimed at boosting the capabilities of the domestic enterprise sector, notably through industry-specific and small and medium-sized enterprise policies.

The various objectives of education, science and technology, competition and investment policies can be mutually reinforcing. Whether a country tries to connect with global networks by promoting inward FDI, outward FDI, licensing technology, the inflow of skills or through any other mode, policies need to be coherent with broader efforts to strengthen the NIS. The stronger the NIS, the greater is the likelihood of attracting R&D by TNCs and of benefiting from spillovers generated by such R&D. The policies pursued need to be part of a broad strategy aimed at fostering competitiveness and development.

The emphasis on policy coherence is one of the more important lessons learned from those countries that are now emerging as more important nodes in the knowledge networks of TNCs. In many of these countries, the starting point has been a long-term vision of how to move the economy towards higher value-added and knowledge-based activities. The success of some Asian economies is no coincidence; it is often the outcome of coherent and targeted government policies aimed at strengthening the overall framework for innovation and knowledge inflows. In some form (and to varying degrees), they have actively sought to attract technology, know-how, people and capital from abroad. They have invested strategically in human resources, typically with a strong focus on science and engineering; invested in infrastructure development for R&D (such as science parks, public R&D labs, incubators); used performance requirements and incentives as part of the overall strategy to attract FDI in targeted activities; and strategically implemented IPR protection policies.

For many developing countries with relatively weak innovation capabilities any expectation of a major influx of R&D by TNCs would be unrealistic in the short term. However, that is not an excuse for a lack of action. Rather, countries should consider how to begin a process through which economic and technological upgrading could be fostered. For latecomers, ensuring that a process aimed at strengthening their NIS gains momentum is an essential first step.

For home countries, current trends accentuate the need to rely even more on the creation, diffusion and exploitation of scientific and technological knowledge as a means of promoting growth and productivity. Rather than regarding R&D internationalization as a threat, home countries should seize opportunities arising from it. It is important to explore new ways of collaborating with the new R&D locations (e.g. through joint research programmes and careful attention to the benefits and costs of outsourcing and R&D-related outward FDI). Countries should also try to remove bottlenecks and "systemic inertia" in their NISs to be better positioned to benefit from R&D internationalization. They may also see the need to specialize more in areas where they hold a competitive edge to strengthen existing world-class centres of excellence and build new ones.

For the world as a whole, this recent trend of R&D internationalization should help speed up the innovation process and facilitate more cross-border flows of knowledge and technology.

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# Part II

# Towards Greater Investment Mobility

# Session 1: Competition for Investment Promotion: Does Industry Targeting Work?

**Presentations**

Mr. Michael Gestrin, Senior Economist, Investment Division, OECD

Mr. Joseph Battat, Lead Investment Policy Officer, Foreign Investment Advisory Services, World Bank

Prof. Andrew Charlton, Professor, London School of Economics and Political Science

# The Policy Framework for Investment: The trade policy and investment promotion and facilitation chapters

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Investment has proven to be a powerful catalyst for innovation, sustainable growth and poverty reduction. Despite positive trends in the past decade, business investment and enterprise development in non-OECD regions continue to fall short of development needs. The Monterrey Consensus identified private capital, including foreign direct investment, as "vital complements to national and international development efforts" and emphasised the need "to create the necessary domestic and international conditions to facilitate direct investment flows". These necessary conditions include "a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions" (Paragraph 21).

The OECD Investment Committee, in partnership with non-Members, embarked on a pioneering exercise in 2003 in Johannesburg, South Africa, when it launched work on a *Policy Framework for Investment*. The *Framework* is based upon the shared recognition that 1) good policies matter; 2) lessons from mutual experience exist on what constitute the main features of good policy for investment; and 3) cross-policy coherence is vital in government efforts to improve the investment environment.

The *Framework* is intended as a non-prescriptive checklist of issues for consideration by any interested governments engaged in domestic reform, regional co-operation or international policy dialogue aimed at creating an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to society. The *Framework* could also serve as a reference point for investment promotion agencies, donors as they assist recipient country partners in improving the investment climate, and businesses, trade unions, and NGOs in their dialogue with governments. It recognises that the needs of countries at different levels of development call for a flexible and non-prescriptive approach that provides constructive policy guidance across a range of areas in order to maximise the contribution of investment to development.

The *Framework* is being developed by a Task Force through a partnership process involving OECD Members and any interested non-Member Governments, in co-operation with civil society and other international organisations. The *Framework* covers ten policy areas that contribute to a healthy investment environment: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; policies for promoting responsible business conduct; human resource development; infrastructure development; and public governance. In addition to host-country policy action, the contribution of international co-operation, including through regional integration and home-country policy action, is also addressed.

During the APEC-OECD seminar, two of the chapters of the PFI were reviewed and discussed; trade policy and investment promotion and facilitation.

***Trade policy***

A country's trade policy determines the conditions under which goods and services are allowed into its national market. The relevance of trade policy from an investment perspective owes to the complex economic relationship between trade and investment. Firms have a multitude of modalities for serving markets, including, *inter alia*, trade, foreign investment, strategic alliances, and licensing. Furthermore, different types of investment have been associated with different firm motives, such as asset, resource, and market-seeking investment. Depending upon the motives behind investment and the exact form that the investment takes (e.g. fully-owned subsidiary versus a strategic alliance involving a minority equity stake), foreign affiliates are likely to exhibit different patterns of behavior with respect to trade.

Nevertheless, the secular trend has been in the direction of more trade-intensive investment. This is highlighted in the increasing share of intermediate inputs in U.S. affiliate trade beginning in the late 1980s and the doubling of intra-firm exports in Japanese trade during the 1990s. The highest rates of growth in intra-firm trade, albeit starting from lower levels, have been in developing countries. This general trend strongly suggests that the investment choices of firms have become more sensitive to trade policies.

The close links between trade and investment have been reflected in the growing tendency of international agreements to address trade and investment issues together. For example, regional trade agreements increasingly cover investment issues and a number of WTO agreements now cover trade-related investment issues at the multilateral level. The General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) and the plurilateral Agreement on Government Procurement include provisions relating to the entry and treatment of foreign enterprises and the protection of certain property rights. The Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Subsidies and Countervailing Measures (ASCM) circumscribe the ability of WTO members to apply certain kinds of measures to attract investment or influence the operations of foreign investors.

Although the relationship between trade policy and investment is complex, the general consensus is that more liberal trade policies are generally better for promoting growth and investment. An important reason for this relates to the increasingly integrated nature of business activity outlined above, with cross-border supply chains that are increasingly dependent upon trade. Furthermore, just as services have become a more significant component of GDP for most countries, they have also become a more significant component of international trade and production. Despite these developments, it remains that there are many examples of trade policies that are discouraging investment. One of the most notable among these involves intra-regional impediments to trade among developing countries that have the effect of restricting the size of national markets, even though market size is one of the key determinants of investment.[4)] For example, the highest tariff barriers faced by African exports globally are in Africa itself. Another important impediment to investment consists in impediments to trade faced by developing country exporters in the larger, more advanced economies. If investors cannot access the world's largest markets by exporting from smaller, developing economies, the incentive for firms to invest in these is significantly undermined.

*Investment promotion and facilitation*

With respect to investment promotion and facilitation policies, these can be successful if they take place within a broader context of sound economic and structural policies, leading to an environment that is conducive to business. Research suggests that, without an appropriate business climate for investment, promotional efforts might actually make foreign investment less likely. A review the performance of investment promotion agencies in 58 developing and transition shows that investment promotion is more effective in a country with a good investment climate and can even be counterproductive if the country offers only a poor investment climate. Countries with a poor investment climate are better off spending their limited resources on the climate itself rather than on promotion.

However, once a country is establishing a generally sound investment climate, governments can take additional steps to promote and facilitate investment. Foreign investors by themselves might be slow to perceive profitable opportunities in the host economy, especially in smaller, more remote markets or those with a history of political unrest. They might also prefer to deal with existing suppliers elsewhere rather than take the time and effort to establish contacts with local firms. Active promotional policies by the host government can encourage both investment and linkages with local firms. A common institutional approach to such promotion is to create an IPA or other institutional facility.

11) Where countries have relatively free trade among them, market size is not longer determined by national borders.

Not only can the IPA help simplify administrative procedures, improve regulatory transparency and focus investment promotion, it can also serve as a conduit for private sector input into the reform process itself. In many cases, the IPA is also used as a vehicle for expanding linkages between foreign investors and domestic suppliers.

In sum, the chapters on trade and investment promotion and facilitation show that a successful strategy for creating a healthy investment environment involves much more than just reforming investment policies, per se. While these are important, the Monterrey Consensus and the PFI emphasise the need for a broad-based approach towards improving the investment environment and, within this context, the need for policy coherence. Much more can be done by governments to improve the conditions for local businesses to flourish and for international business to maximise its contribution to development.

# Importance of Improved Investment Climate when Competing for Investment: The case of Targeting*

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## Abstract

Developing countries are part of a highly competitive environment to attract beneficial FDI. To do so, countries perform various investment promotion functions, including investors servicing, image building and policy advocacy. Investment targeting, that is going after specific sectors, companies and countries to generate desired FDI flows, is an increasingly popular approach to promoting investment. It is an approach that requires complex sets of skills and is expensive. Without a deliberate inclusion of a parallel program to improve the investment climate, targeting is bound to fall short of its goals, as the product, i.e., the investment climate, it is supposed to promote would be sub par. It is easier to promote a good product, thus it is easier to target successfully, if the investment climate is improving.

The note presents three cases of targeting: Thailand's automobile industry, Chile's high-tech sector and Costa Rica's INTEL project. The paper attempts at documenting how the authorities made serious efforts at improving the investment climate in parallel with each of the three investment targeting programs, and how those efforts have played a crucial role in their success.

## INTRODUCTION

### *1. FDI TRENDS INCREASINGLY COMPETITIVE GAME*

Recent trends in foreign direct investment [FDI] have created an opportunity for developing countries to attract resources, technologies, and skills from overseas, and to access international markets. Many factors help to explain why the growth of FDI was particularly pronounced in developing countries in 2004. Intense competitive pressures in many industries are leading firms to explore new ways of improving their competitiveness. Some of these ways are by expanding operations in the fast-growing markets of emerging

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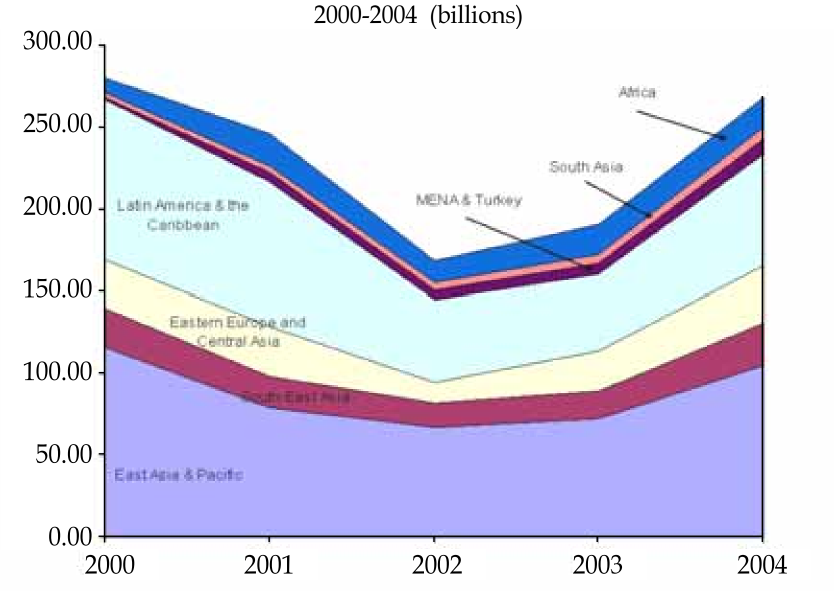
economies to boost sales, and by rationalizing production activities with a view to reaping economies of scale and lowering production costs.

Although FDI to developing countries has fallen by 26 percent since 1999, its growth over the past 13 years has been phenomenal, averaging more than 17 percent a year in dollar terms.[2] The Asia/Pacific region is the largest recipient, as well as source of FDI among developing countries. In 2004, it attracted $105 billion of FDI, $33 billion more than in 2003, marking the largest increase ever driven largely by a significant increase in flows to Hong Kong. In South-East Asia, FDI surged by 48% to $26 billion, while South Asia, with India at the forefront, received $7 billion, corresponding to a 30% rise.[3] (see Figure 1)

**Figure 1. FDI Flows to Developing Countries by Region,**
2000-2004 (billions)



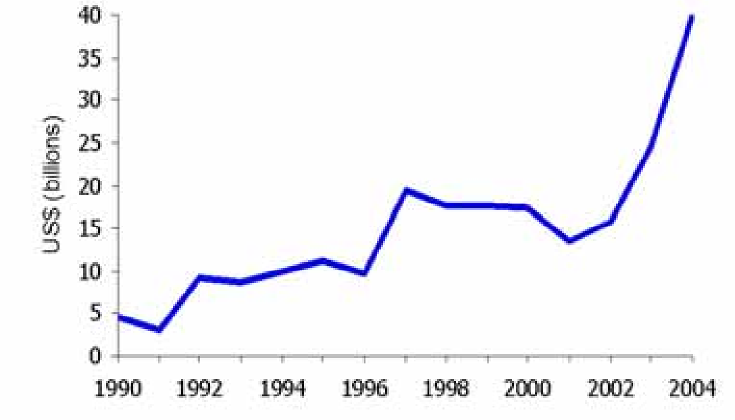

*Source: World Investment Report 2005, UNCTAD*

The Asia and Pacific region is also emerging as an important source of FDI. In 2004, the region's outward flows quadrupled to $69 billion, due to dramatic growth in FDI flows from Hong Kong, and to a lesser extent from other parts of East Asia and South-East Asia. FDI outflows from developing countries have also experienced an impressive increased, from US$5 billion in 1990 to approximately US$40 billion in 2004 (see Figure 2).[4]

This trend have also replicated in regards to FDI inflows between developing countries (South-South), whereby in 2003 it is estimates that about 35 percent of FDI flows to developing countries originated from other developing countries (see Figure 3).

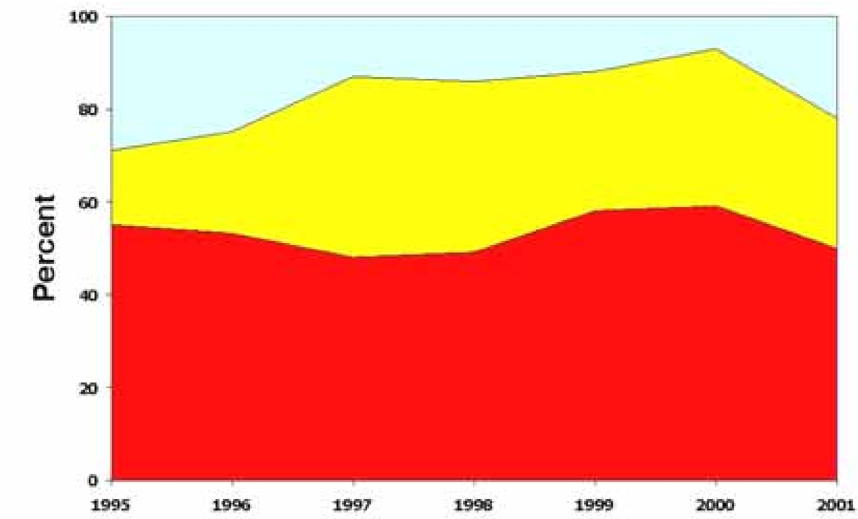
2) UNCTAD, *World Investment Report*, 2005
3) UNCTAD, *World Investment Report*, 2005
4) World Bank. 2005. *Global Development Finance 2005.*

**Figure 2. FDI Outflows from Developing Countries,**
1990-2004 (billions)




*Source: World Bank. 2005. Global Development Finance 2005.*

**Figure 3. Share of FDI inflows to developing countries by origin**

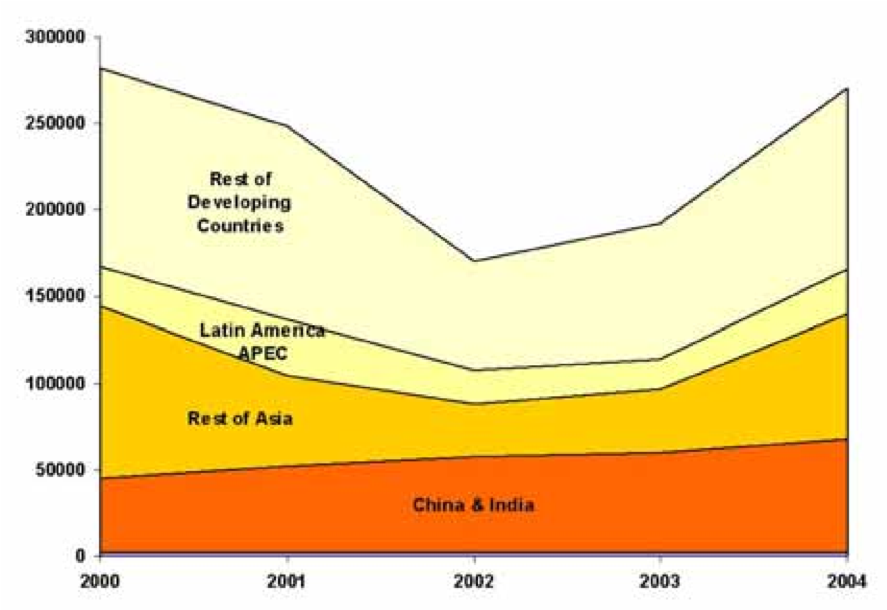



*Source: Dilek Aykut and Dilep Ratha. 2004. "South-South FDI Flows: How Big Are They?" Transnational Corporation*

In recent years, Asia has accounted for much of the increase in FDI flows to developing countries (see Figure 4). Two countries, China and India, are getting the lion share, not only because of the sheer size of their economies, but also due to their spectacular economic performance in the last few years. Forecasts are showing that India, which has been a distant second to China in its ability to attract FDI, is likely to pick up the pace and attract higher flows in the coming years, perhaps intensifying the concentration of FDI flows to those two countries even more.

In this context, developing countries that fail to respond to these trends when developing policies to attract foreign investment could be left behind. What strategies should they pursue to capture these new foreign investment flows? In addition to serious efforts at promoting FDI on the part of investment promotion agencies (IPA), it is also important for developing countries to address microeconomic issues that are important to investors, such as the reduction of burdensome land and tax regulations, and other forms of administrative barriers to investment.

**Figure 4. FDI Flows in Asia, 2000-2004** (million of dollars)




*Source: World Investment Report 2005, UNCTAD*

## 2. *FIVE FUNCTIONS OF INVESTMENT PROMOTION*

- **Investor Servicing.** This function, arguably the most cost- effective investment promotion technique, is badly needed in a country where regulation are difficult, information hard to find and many institutions are still weak. Providing services to existing investors increases awareness of the Investment Promotion Agency, if existent, and encourage re-investments by the existing investor community. Satisfied investors are the best advertisement to encourage new investors to come to a country. With regard to providing facilitation services to potential new investors, the objective should be to convert interested investors into actual ones. To do this, the Government should provide foreign firms with information as soon as they show an interest in the country, help them to organize visits with appropriate people when they come to the country, and once they make a positive decision to invest, assist them through all procedures to build a project in the country.

- **Image Building.** Image building efforts are most effective when a gap exists between the reality of investment conditions in a country and the perception of these conditions by international investors. The use of various image-building techniques can be sensible and beneficial when conducted at the right time but it can be wasteful and counter productive if conducted too early, or when the country offers in reality a 'bad product,' i.e., a poor investment climate, to investors.

- **Targeted Investment Generation.** A country may wish to target specific sectors, companies or even countries to generate FDI flows. Targeting is the reflection of the national economic strategy and priorities. It is a highly skilled activity of investment promotion, requiring a lot of resources. It builds on other functions of investment promotion, including investor servicing, image building and policy advocacy.

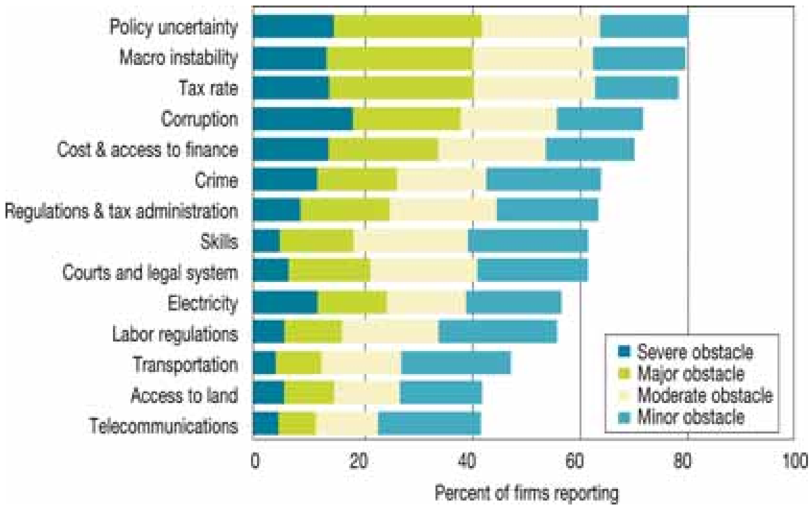
- **Policy Advocacy.** These are efforts related at improving the investment climate by promoting reform of policies, laws, and regulations at the highest level of government, and working with national and local government officials to remove administrative bottlenecks and barriers that investors face. The strategy for improving the investment climate should be systemic—i.e., constraints and bottlenecks should be removed not only at the project level, but for investors in general and at the industry level. Working closely with investors, an IPA is in an excellent position to collect information about investors' reaction to the business environment and the issues they face in the country. Such valuable intelligence can then be passed on to relevant government agencies to deal with them.

- **After-care**. This function relates to dedicated, long-term efforts to servicing the foreign investor after has established in the country. This is perhaps one of the most important functions as it contributes to establish a long-term relationship with the investor in the country; contribution to investment retention; and it is a powerful instrument to attract potential investors into the country.

### *3. policy advocacy: regulatory changes favorable to fdi*

In addition to broadening the scope of investment promotion tools, countries must recognize that the battle for FDI will increasingly be fought at the microeconomic level sector by sector. Although, foreign investors will continue to insist on basic political and macroeconomic stability, this should become less important as a differentiating factor. Investors will look increasingly at microeconomic conditions, and what they look for will vary significantly from one sector to another (see Figure 5). For example, the requirement

**Figure 5. How do firms in developing countries rate various investment climate constraints?**




*Source: World Development Report, 2005, World Bank*

for efficiency-seeking investment in manufacturing include low factor of production costs, a flexible and efficient labor market, a small regulatory burden, access to a competitive supplier base and business service providers, and efficient infrastructure and customs.5) In addition, unfair competition from tax-evading low- productivity informal players has been found to be among the biggest constraints to FDI growth in domestic services in most developing countries.

Businesses in less developed countries face much larger regulatory burdens than those in richer countries. They face three times the administrative costs, and nearly twice as many bureaucratic procedures and delays associated with them. And they have fewer than half the protections of property rights of rich countries. Heavy regulations and weak property rights exclude the poor from doing business contributing significantly to informality, which in poorer countries is 40% of the economy.6)

Resolving these investment climate issues benefits both FDI as well as domestic private investors—and thus is essential to boosting growth and reducing poverty. Samples of investment climate factors that are important to investors are:

5) "Foreign Direct Investment Trends: Looking Beyond the Current Gloom in Developing Countries", Public Policy Journal 273. World Bank, Washington, D.C., September 2004. Victor Palmade and Andrea Anayiotas

6) Doing Business 2005, World Bank Group (http://www.doingbusiness.org)

*Investment Climate factors*

A. Administrative Barriers
B. Fiscal policy and administration
C. Investment Law / Policy
D. Competition Law / Policy
E. Land reform
F. Labor Policy
G. Corporate Social Responsibility

*Source: Foreign Direct Investment Service (FIAS), World Bank Group, http://www.fias.net*

## *4. CASE STUDIES*

The following case studies illustrate the interaction between targeting and improvement in the investment climate. They show that by improving the latter, the former is likely to be more successful.

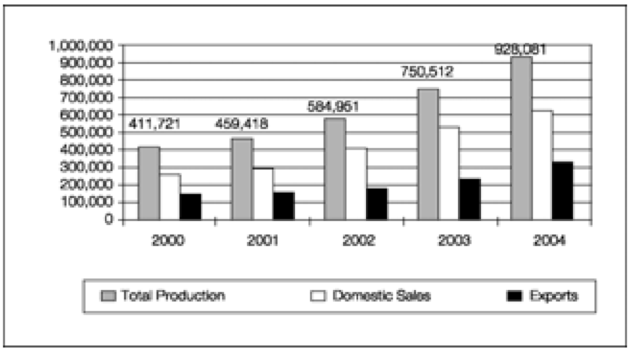
### a. Thailand Auto Cluster

Thailand has long maintained an open, market-oriented economy and encouraged foreign direct investment as a means of promoting economic development, employment, and technology transfer. The country investment targeted program in the automobile cluster is an example of the country's investment promotion strategy. With over 700 auto parts suppliers and 1,000 in supporting industry together employing more than 217,000 workers, Thailand enjoys a reputation for having a strong auto-parts supply base to support the automobile manufacturing industry.

Auto parts development and assembly started over 30 years ago. The first auto cluster formed around Bangkok, where assemblers and parts suppliers had established plants. During a second wave of cluster development (Eastern Seaboard, from the 1990s to present), assemblers built new plants, with an rapid increase in the number of parts manufacturers moving to Thailand, following the establishment of Ford and GM plants.

Thailand's Government played a major role in formation of Eastern Seaboard auto cluster. For instance, it supported the weaker parts of the value chain with customized auto cluster incentives; developed a skills, technology and innovation incentive package; and "priority activity" status to investment in identify key components. Priority activity status confers the maximum incentives of eight-year tax holidays, duty-free machinery, and other important rights and benefits and facilitation services. On a more general investment climate basis, the Government improved infrastructure facilities and networks such as

**Figure 6. Thailand's Automotive Market Growth**




Source: The Thai Automotive Industry Association

international ports, roads and distribution systems, to boost and support the automotive production to meet the 2005 goal of 1.1 million units, an 18% expansion over 2004, and to achieve the manufacturing target of 1.8 million units by 2010 (see Figure 6).

Thailand's auto cluster program has positioned Thailand for the second year in a row as the 20th easiest country in the world in which to do business; this, according to the September 2005 report, "Doing Business in 2006: creating Jobs," cosponsored by the World Bank and the International Finance Corporation (IFC)[7]. Thailand this year scored in the top 25% in 7 out of 10 of the indicator categories. Virtually all of Thailand's scores in the 7 categories repeated from last year's report either remained the same or significantly improved. Thailand's foreign direct investment (FDI) surged by 56% to 178 billion baht (US$ 4.5 billion) in the first half of 2005, led by Japan[8]. Thailand has become the biggest auto manufacturers in ASEAN and Thailand's policies toward foreign investors have moved the country from the 29th to the 27th position in the World Competitiveness Ranking (IMD).[9]

Still, there exist many opportunities for foreign investors, and Thailand's BOI has increasingly focused on attracting high-technology investments geared towards taking Thailand to the next level as the "Detroit of Asia." The BOI is attracting high-level parts suppliers by offering 'priority activity' status to investments in identified key components. These include production of electronic fuel injection systems, molds and dies, jigs and fixtures, anti-lock braking systems, and substrates for catalytic converters. With attractive tax benefits and facilitation services, the BOI hopes that Thailand will attract investments to produce the last key components missing or not sufficiently produced in Thailand. In addition, the BOI also gives maximum incentives to activities that support the development

7) Doing Business 2005, World Bank Group. (http://www.doingbusiness.org)
8) Thailand's has experience significant increase in its FDI inflows during the last years: US$947 million (2002), US$1,952 million (2003), and US$1,064 million (2002). World Investment Report 2005, UNCTAD.
9) World Competitive Rankings by IMD (Institute for Management and Development, The Year of Competitiveness 2005)

of target sectors such as the auto industry. These activities include R&D, design activities, and human resources development.

More recently, the Thailand Automotive Institute (TAI) has developed an 8.7 billion baht (US$ 217.5 million) plan to set the Kingdom on the road to achieving the 1.8 million production goal and fulfilling the "Detroit of Asia" aspiration. The proposal consists of the following five key projects:

- A 1.5 billion baht (US$ 37.5 million) human resources development program
- A 500 million baht (US$ 12.5 million) automotive experts dispatching program to establish clusters and upgrade auto parts manufacturing technology.
- A 500 million baht (US$ 12.5 million) information technology center to analyze industry trends
- A 200 million baht (US$ 5 million) automobile export promotion center. The government may broaden Thailand's automotive specialization beyond pick-up truck production to include passenger car manufacturing, with the implementation of the "Best Little Car" project. The project is expected to result in the creation of a new segment requiring new production lines, increased sales for manufacturers and less expensive vehicles for consumers.

In addition to the incentive packages and improvements in the investment climate, Thailand's strategy provides a conducive environment for the auto sector to thrive in the country. It avoids championing a particular company or auto model, and leaves it to investors to make their own investment decisions and take advantage of the environment presented by the authorities.

**b. Chile High-Tech *(Invest@chile)***

The Chilean Economic Development Agency (CORFO)[10] launched in 2000 the investment-targeting program, *Invest@Chile*. The program, sponsored by the Ministry of Economy, was designed to attract and facilitate technology-intensive foreign investments in the country. The program, which also operates in coordination with the Foreign Investment Committee, is positioning Chile as a technology and service springboard for companies to launch investment project into Latin America.

*Invest@Chile* has followed three approaches:

- Improve Chile's visibility by promoting the country's advantages among

10) CORFO (http://www.corfo.cl)

international IT business community.

- Generate investments in Chile by identifying companies, projects and business leaders currently looking for IT consolidation or location alternatives.
- Support investors with services and information to win investment decisions for Chile and aid the development and completion of business projects.

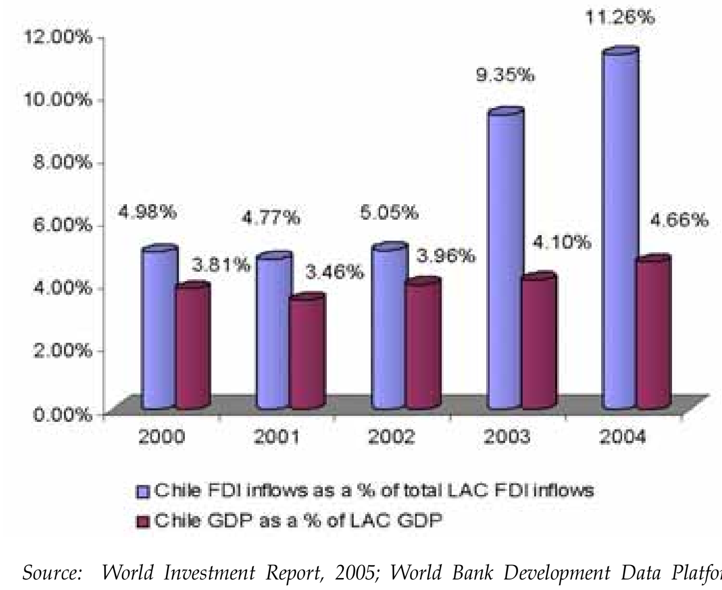
The program has focused on key sectors including Shared Services, Contact Centers, Help Desk Services and e-Commerce and Software Development (wireless solutions, operational-logistics software for natural resources industries, financial solutions, etc.).

Since the program inception, the country has attracted over 35 international firms exporting over US$100 million to this date. These numbers are the result of the Chilean Government successful promotion strategy, which was based on direct marketing, focused on selected investors. The country which begun with the identification of potential investors from lists such as Global 500 firms in Latin America and followed-up with meetings with selected investors in the high-tech international services. Nonetheless, Chile's promotion efforts were closely linked to a favorable investment climate, which investors have found attractive.

For the last three decades, Chile has made foreign direct investment (FDI) an essential part of its national development strategy (see Figure 7). Chile's sound, market-oriented policies have created significant opportunities for foreign capital to participate in the country's impressive economic growth. Chile's business climate is generally straightforward and transparent and foreign investors receive national treatment in nearly all sectors.

The country's welcoming attitude toward FDI is embodied in the country's 1974

**Figure 7. Chile FDI inflows as a % of total LAC FDI inflows compared to Chile GDP as a % of total LAC GDP, 2000-2004**




*Source: World Investment Report, 2005; World Bank Development Data Platfor* foreign investment statute[11], which has been the main regulatory norm for FDI in Chile during the last 30 years, due to the benefits, and assurances that it establishes. The Foreign Investment Committee (FIC) is the entity responsible for administering the statute, establishing the terms and conditions of the investment. Applications are typically approved within a matter of days and almost always within a month and the authority of the Foreign Investment Committee to reject a foreign investment is severely limited by the Chilean Constitution.

Recently, Chile took additional measures to become even more attractive to investors. In November 2002, the Chilean Government launched an Investment Platform initiative aimed at attracting international operations headquarters for the region to Chile. As part of this initiative, a company that is set up exclusively as a platform for investments abroad and in Chile is exempt from Chilean income tax on the profits that overseas shareholders derive from its investments outside Chile. Up to 75 percent of the platform company's shareholders may be resident in Chile; non-resident shareholders may not reside in tax havens. If a platform company invests in Chilean assets, it must pay tax on profits derived from these investments. Similarly, the earnings of the platform company paid to Chilean shareholders are liable for the same tax (and have the same right to tax credits) as an investment abroad that repatriates profits to Chile.

### c. Costa Rica Electronics *(INTEL)*

While the case of Costa Rica's INTEL is not new, it is presented here for its continuing relevance and its subsequent impact on the country.

In November of 1996, Intel Corporation announced plans to construct a $300 million semiconductor assembly and test plant in Costa Rica. The announcement came as a triumph to Costa Rican authorities, who had worked for months to attract the U.S-based technology powerhouse. With annual revenues of over $20 billion Intel is one of the world's largest and most profitable corporations. With a population of 3.5 million and only limited development in electronic and other high-technology sectors, Costa Rica was an unlikely choice for Intel.[12]

Costa Rica explicitly targeted the electronics sector as an area of high potential growth. Like other countries, it also sets its sights on increasing flows of foreign investment to the country and created an investment promotion agency (CINDE) to attract and convince potential investors. But whereas other countries have seen industry-specific promotion efforts stagnate or stumble, Costa Rica appears to have succeeded quite well.

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11) Chile Foreign Investment Committee, Foreign Investment Statue D.L 600 http://www.foreigninvestment.cl/index/publications2.asp?id_seccion=6&id_subsecciones=87

12) "Attracting High Technology Investment: Intel's Costa Rican Plant", Foreign Investment Advisory Service, Occasional Paper 11, 1998. Deborah Spar

Four elements, in particular, appear to have impressed Intel to select Costa Rica: political and social stability; a commitment to economic openness and liberalization; an explicit focus on economic development in the electronics sector; and a receptive investment climate for foreign investors (see Figure 8).

**Figure 8. Intel's Selection Criteria**

- Stable economic and political conditions
- Human resources
- Reasonable cost structure
- A "pro-business" environment – Government interested in assisting economic development and foreign investment.
- Logistics and manufacturing lead time
- Fast Track permit process – All necessary permits within 4-6 months

Since 1982, Costa Rica moved quite dramatically away from its prior policies of import substitution and embraced a relatively aggressive program of economic liberalization. On the FDI front, Costa Rica has been particularly energetic. Not only has it accepted the idea of FDI, but it has also taken discrete measures to attract and sustain investors. It established a series of free trade zones beginning in 1981, and bundled them with financial and operational benefits designed to lower the hurdles for potential investors. More importantly, Costa Rica made clear that foreigners invested in the country would be subject to precisely the same laws as Costa Ricans. There is no legal distinction in Costa Rica between foreigners and local citizens with respect to property ownership and business operations.[13)]

For the semiconductor assembly and test facility that Intel intended to construct, these demonstrations of openness and liberalization were critical. While Costa Rica may not have had the most attractive incentive package of all the contenders, it had a clear and credible track record of liberalization and fair treatment. Moreover, realization of the value of the country's well-educated workforce became the centrepiece for a strategy focused on electronic, and specifically designed to attract investment from medium- and high-technology foreign firms.

To some extent, a strategy of attracting high technology FDI is not particularly novel. Many developing countries have indicated similar interest in attracting these firms. Costa Rica though took this attractive strategy several steps further. The country already had not just a low wage labor pool, but a very well-educated low wage, therefore competitive, labor pool. This is a central and critical distinction. Costa Rica has already invested heavily in education and technological training. With this strategy in place, CINDE succeeded between 1992 and 1995 in attracting a number of small investments in the electronic manufacturing area. This established base made it relatively easy for Intel to consider

13) "Attracting High Technology Investment: Intel's Costa Rican Plant", Foreign Investment Advisory Service, Occasional Paper 11, 1998. Deborah Spar

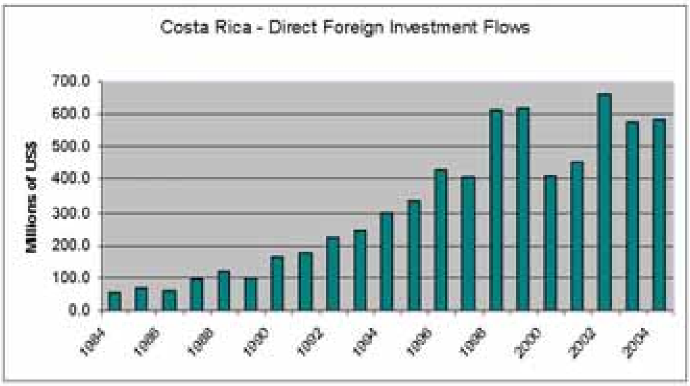
investing in the country.

A rapid and dramatic impact was on foreign direct investment (FDI) into Costa Rica. Intel investment inflows started in 1997 and skyrocketed in 1998 and 1999. As Figure 9 shows, each of these years Costa Rica received more than $600 million in new FDI, an increase of about 50% over the average in 1996-1997. Overall, Intel has invested more than $510 million, including its most recent re-investment of $110 million in the A&T line for chipsets. This project was reflected in 2004, helping to boost total FDI flows to $585 million. The "Intel effect" on the country's FDI inflows has enabled Costa Rica to significantly outperform all other countries in Latin America: between 1999 and 2003, FDI flows fell 7%, compared to the regional average of 55%.[14]

The country's gross domestic product (GDP) has also been intrinsically tied to Intel. GDP and GDP per capita surged in 1997 through 1999. In 1999, Costa Rica's GDP grew 8.4%, but excluding Intel's contribution, it would have grown only 3%. Thus, more than 60% of GDP growth in 1999 could be directly attributed to Intel.[15]

However, Costa Rica's GDP also shared Intel's downturns. When Intel activity dropped significantly in 2000, the country's GDP growth was held to just 1.4%. Without Intel, GDP would have grown 3%. This experience led to the realization in Costa Rica that companies such as Intel were subject to business cycles, and consequently, the country needed to diversify its investment projects with other companies, sectors and markets.

**Figure 9. Costa Rica: Direct Foreign Investment Flows**




*Sources: Central Bank of Costa Rica, COMEX, PROCOMER, ICT, CINDE*

### *5. LESSONS LEARNED*

A number of lessons can be drawn from examining the relationships between targeting in investment promotion and improving the investment climate. The first lesson is that to formulate and implement an investment targeting strategy and program requires highly

14) Multilateral Investment Guarantee Agency (MIGA). Intel data summary, 2005
15) Multilateral Investment Guarantee Agency (MIGA). Intel data summary, 2005

complex sets of skills. Even that is not sufficient.

So the second lesson is that serious consideration and efforts at improving the investment climate are a must if targeting is to succeed. Essentially, it is easier to promote a product, if that product is of a higher quality. So the investment climate, that is the product here, is more sellable if it is improved. Improvements have been made both at the general level, and for elements of the investment climate that are of direct relevance to the targeted sectors.

The third lesson is that targeting needs to be formulated and implemented in conjunction with a multi-functional investment promotion strategy and program. To be successful, investment targeting profits from successful image building campaigns. It has to rely on solid investors servicing and facilitation once investors are attracted to the country to explore investment opportunities. And policy advocacy plays a key role in the process of improving the product, i.e., the investment climate that targeting attempts to promote.

# Industry Targeting within Foreign Investment Promotion - A survey of the targeting practices of 122 investment promotion agencies

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## Executive Summary

Investment promotion is an important, widespread, and growing element of national economic development policies. More than 160 countries have national investment promotion agencies (IPAs), which promote and attract foreign direct investment (FDI). Increasing global competition for FDI funds, limited budgets, and, in some cases, mandates to contribute to specific national industry policies have resulted in an increase in IPAs' industry targeting activity ─ that is, the practice of focusing investment promotion resources on a small number of 'target' industries, rather than promoting FDI in general.

This paper reports the results of a survey into the industry targeting practices of 122 national IPAs, of which 23 are from OECD countries and 99 are non-OECD countries.

All the IPAs we surveyed contributed information about the extent to which they target industries and the types of industries they target. We conducted detailed interviews with senior managers from a smaller number of IPAs to identify the reasons for choosing each of their target industries, the extent to which their portfolio of target industries forms part of a broader targeting strategy, and the relationship between targeting strategy and broader national economic development plans and industry policies administered by other government agencies.

The findings of this report provide investment promotion agencies with useful benchmarking information against which to compare their own targeting practices and strategies. This report also provides an analysis of trends in industry targeting in relation to FDI inflows and economic development.

***Summary findings of this report:***

***Industry targeting is widespread, competitive, and usually a function of a country's current degree of industrialisation***

More than 70% of the countries surveyed selectively promote some industries above others for FDI.

Targeting is particularly prevalent in small countries and rich countries. More than 85 per cent of OECD countries in the survey reported target industries.

The manufacturing sector accounts for the largest share of target industries. The industries in which competition for FDI is most intense are: electronics and electrical equipment, information and communications technology, and food related products.

In most cases, an IPA's choice of target industries appears to depend upon the characteristics of the IPA's domestic economy. The data confirm that more developed countries focus on higher-tech industries; low-wage countries focus on lower-wage industries; and countries with better educational attainment focus on higher skill industries.

However target industries of some countries appear to be misaligned with their economic characteristics. While most countries display a clear relationship between their level of economic development and their targeted industries, there are cases where countries clearly diverge from their peers in this respect. For example, several countries target high-tech industries in which they have little existing capability or comparative advantage.

***IPAs use various criteria when choosing target industries. These criteria can generally be characterised as either relating to the attractability of the industry or the desirability of the industry***

The vast majority of IPAs reported criteria for the selection of targeted industries that amount to an assessment of the relative attractability of FDI in that industry. For example, many IPAs reported that they evaluate the extent to which a country's particular characteristics provide the IPA with a competitive advantage in that industry. Many countries also analyse the global mobility of the industry as an indicator of attractability.

Most IPAs also emphasised choice criteria reflecting the significance of the desirability of potential target industries in the context of general economic objectives such as job creation and the potential value of the industry to an existing or proposed local cluster.

A small number of IPAs described a portfolio of target industries which were linked to each other in a forward-looking economic development strategy, combining short-term strategies for maximizing attraction with long-term development goals.

Whether a country targets, and which industries it chooses, appears to affect its FDI

Measured in terms of smoothed FDI/GDP data over a seven year period (1995-2002), the countries that we surveyed which practice industry targeting seem to attract more FDI than those that do not target industries.

Countries which target industries that are not aligned with their national characteristics seem to attract less FDI.

***There are many aspects of targeting that require further research. Outstanding questions include:***

Is it possible to measure the success of a targeting strategy? This paper describes several targeting methodologies. We are able to compare strategies across countries and comments on the apparent merit of alternative choices, but we lack clear performance criteria with which to analyse the success of individual targeting strategies.

Is it possible to design an objectively optimal targeting strategy for IPAs based on country characteristics and development objectives? This paper suggests a matrix-based model for managing the trade-offs between the low-value/attractable industries, and high-value/desirable industries. A detailed comparative study of targeting methodologies may be useful to countries who are considering changing their industry targets.

What is the impact of industry targeting? This paper makes general observations concerning possible links between targeting practices and FDI inflows, however more detailed and technical analysis is left for future research.

## Industry Targeting

*Key findings:*

***1.0 Industry targeting is widespread, competitive, and usually a function of a country's current degree of industrialisation***

- 1.1 More than 70% of the countries surveyed selectively promote some industries above others for foreign direct investment.
- 1.2 Targeting is particularly prevalent in small countries and rich countries. More than 85 per cent of OECD countries in the survey reported target industries.
- 1.3 The manufacturing sector accounts for largest share of target industries. The industries in which competition for FDI is most intense are electronic and electrical equipment, information and communications technology, and food related products.
- 1.4 Most IPAs' choice of target industries appears to depend upon the characteristics and capabilities of their domestic economy: the data confirms that more developed countries focus on more higher-tech industries; low-wage countries focus on lower-wage industries; and countries with better educational attainment focus on higher skill industries.
- 1.5 Some countries' target industries appear to be misaligned with their economic characteristics. While most countries display a clear relationship between their level of economic development and their targeted industries, some countries clearly diverge from their peer groups. For example, several countries target hi-tech industries in which they have little existing capability or comparative advantage.

### *1.1 Industry targeting is widespread*

The practice of focusing investment promotion resources on a small number of priority sectors is a growing and pervasive phenomenon among IPAs. More than 70 per cent of the IPAs in our sample reported target industries.

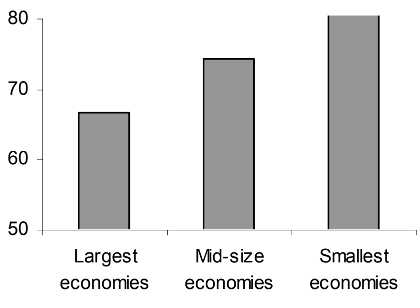
The IPAs we interviewed reported that they targeted for a number of reasons. Efficient use of investment promotion resources was the most common response, with 80% of interviewed IPAs stating that targeting represented an efficient use of their investment generation budget. Other responses included the view of industry targeting as a sophisticated form of investment promotion (to follow and build upon image-building efforts), and many stated that targeting was required by their ministry, development agency or other associated government departments.

### *1.2 Smaller and richer countries are the most likely to target*

The survey reveals that targeting is most popular among smaller economies. In figure 1 our sample of surveyed countries is divided into three segments according to the size of their economy (GDP). The smaller countries clearly have a larger propensity to target specific industries.

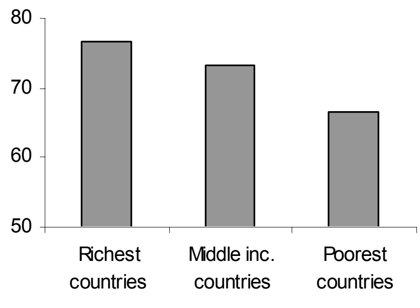
This result may reflect the fact that smaller countries have fewer resources to put towards investment promotion and thus have a greater incentive to concentrate their funds on sectors where their chances of success are highest. Smaller countries may also have less diversified economies which are particularly suited to a small number of industries but may not have the scale, infrastructure, natural resources, or other key requirements to develop clusters in all sectors.

**Figure 1. Small countries are more likely to target industries(GDP)**
(% of group reporting target industries for FDI)




Source: OIR Survey. FDI data from World Bank.

**Figure 2. Rich countries are more likely to target industries (GDP/Capita)**
(% of income group reporting target industries for FDI)



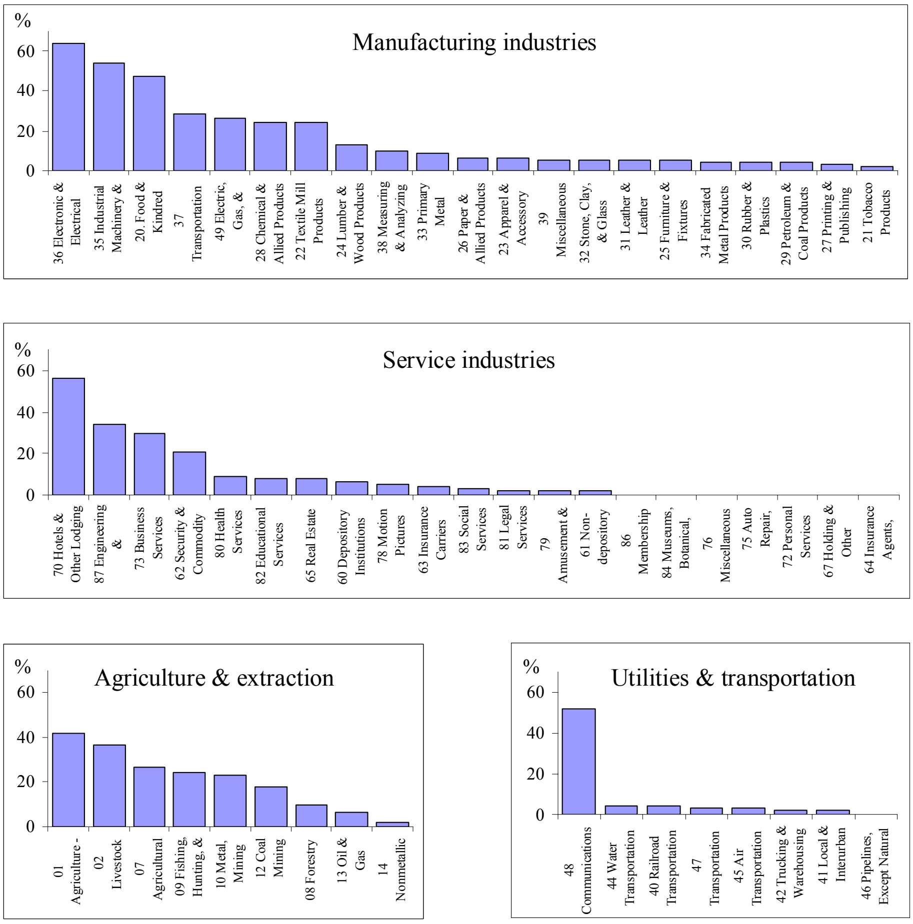

Source: OIR Survey. FDI data from World Bank.

The survey also reveals that marginally richer countries (higher GDP per capita) tend to target more than poor countries in our sample. Figure 2 divides our sample into three groups by national income level (GDP per capita). A marginally higher proportion of richer countries target industries. This potentially reflects the extra cost and expertise associated with selecting and administering a targeting program. Targeted promotion is an expensive process. It often goes beyond direct mail and telephone marketing, involving personal contact with industry groups and individual firms. Often this means extensive travel including attendance at trade conferences, visits to the firms head office and sometimes a corresponding site visit to the host country paid for by the IPA or other government department. Targeted promotion also requires considerable expertise. Matching the requirements of a specific firm to the host country’s competitive advantage necessitates detailed knowledge of the sector, industry and firm which is targeted.

### *1.3 Industry targeting is competitive in a core group of industries*

**Figure 3. Proportion of surveyed countries targeting each industry**

Industries listed by 2-digit standard industry classification code (SIC) and industry name



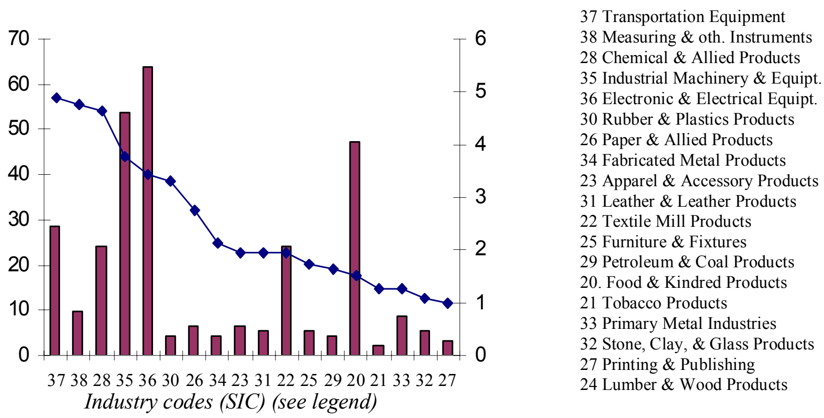

*Source: OIR survey*

Figure 3 reveals significant competition for FDI in a small number of industries. The figure shows the proportion of countries that are targeting each industry (where industries are classified by 2-digit standard industrial code (SIC)).

Six industries — electronics and electrical equipment, tourism and tourist amenities, industrial machinery and equipment, information and communication technologies, food and kindred products, and crop agriculture — are targeted by more than 40 percent of the countries surveyed while 53 industries are targeted by less than 10 per cent of countries. Several industries including those in the wholesale and retail trade sectors are hardly targeted at all.

**Figure 4. High-tech industries are the most commonly targeted in the manufacturing sector, with the exception of food products.**

Left axis: % of countries targeting each industry. Right axis: technology index




Note: The technology index is a measure of the level of technology used in an industry. It is calculated as a function of the ration of total expenditure of the industry on research and development to the total sales of the industry.

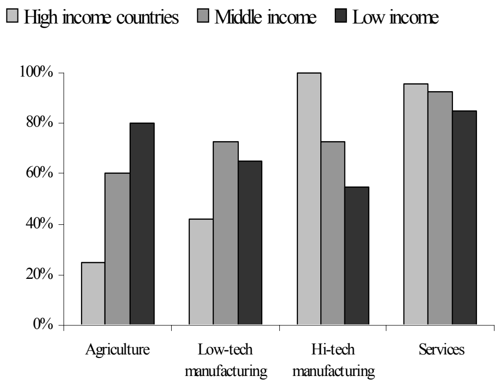
Figure 4 reveals further detail about competition within the popular manufacturing sector. The most competitive industries, with the exception of food products, tend to be those which embody the highest technology. The figure plots the technology index[16] for each of 18 manufacturing industries and the proportion of countries that target each industry. The highest technology industries, including machinery, electronic, and transportation (automobiles) tend to be targeted by the most countries.

1.4 Most IPAs' choice of target industries appears to depend upon their domestic economies' characteristics

In general, the target industries of surveyed IPAs reflect the level of development of the host country. Low income countries tend to target more agricultural and low-tech manufacturing industries while high income countries target more hi-tech and service

16) The technology index is a measure of the level of technology used in an industry. It is calculated as a function of the ratio of total expenditure of the industry on research and development to the total sales of the industry.

**Figure 5. Richer countries target higher-tech manufacturing industries and services.**
(Proportion of countries in income group targeting at least one indusrtry in the sector)



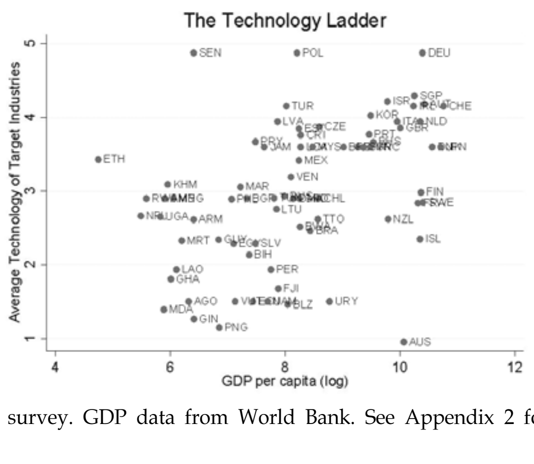

Source: OIR survey. GDP data from World Bank.

industries. Figure 5 demonstrates that the higher-tech industries are the most sought after by targeting IPAs, and that IPAs in less-developed countries target lower-tech industries than IPAs in advanced industrial countries. Only 22 per cent of high-income countries target an industry in the agricultural sector whereas 82 per cent of low income countries target at least one agricultural industry.

Whereas Figure 5 shows that high-tech industries are the most popularly targeted within manufacturing, Figure 6 shows that not all countries target the same industries. In particular, there is a clear 'technology ladder', where the richer countries target more high-tech industries.

Figure 6 plots GDP per capita of each country in the survey against the average technology index of its target industries. A clear pattern emerges which demonstrates the strong link between each countries level of development and the characteristics of their

**Figure 6. More developed countries target higher-tech industries**
(Average technology index in target industries v GDP per capita**)**

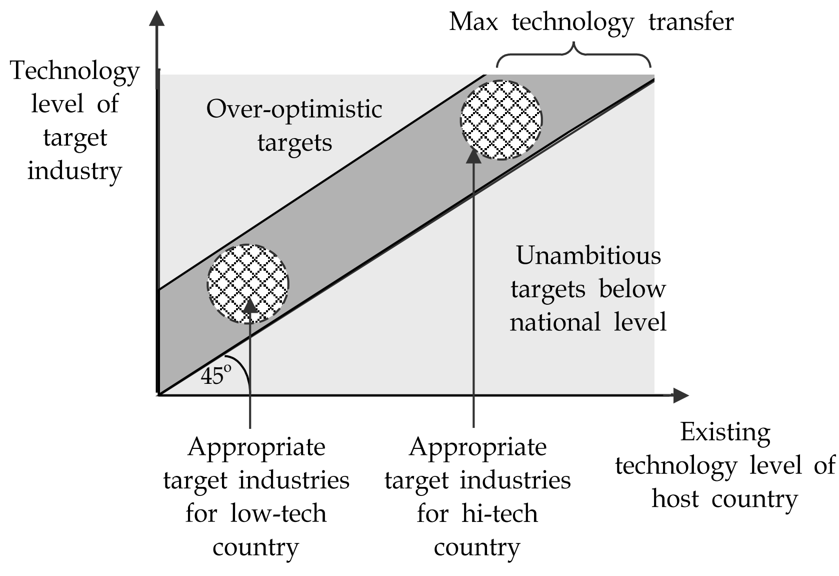



Source: OIR survey. GDP data from World Bank. See Appendix 2 for large version.

target industries. Low GDP countries generally aspire to attract lower-tech industries (south-west corner of the diagram) while advanced industrial countries aspire to attract higher-tech industries.

**The Technology Ladder:** Survey interviews revealed that, to the extent that technology considerations form part of the targeting choice, IPAs choose targets to deliver the maximum technology transfer to their economies. But IPAs face an important constraint. If domestic industrial capabilities are weak, domestic firms will be unable to learn from the high-tech firms: the 'knowledge-gap' is too great.[17] Also, without the required threshold levels of technology and human capital, the location is unlikely to be able to attract high-tech FDI, and the IPA would be wasting promotion resources if it attempted to do so. This suggests that maximum learning occurs from industries which embody more technology than the national domestic average, but not so much more that domestic firms have difficulty learning from them. Figure 7 illustrates this argument. Maximum technology transfer comes from target industries which exist in a range above the 45 degree line where the target industries are more technology-intensive than the domestic economy.

**Figure 7. To maximise technology transfer, countries target industries just above their existing national capabilities**



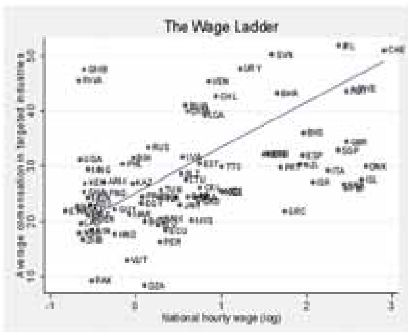

**The Wage Ladder:** Countries with low wage rates have a comparative advantage in the attraction of low-skill labour-intensive industries. Their targeting strategies reflect this advantage. Figure 8 shows the relationship between the hourly wage in each country and

17) On the relationship between local capabilities and spillovers, see Blomstrom, and Kokko (2003).

the average wage across their target industries. Average national hourly wages are generally lower in countries with low human capital levels. Low wage countries (in the south-west corner of the figure) tend to target industries which pay lower average wages because they are able to offer them cost advantages. Low wage countries, whilst theoretically offering even greater cost advantages to high-wage/high-skill industries appeal less to higher-skill industries because they often lack the necessary supporting pool of skilled labour and human capital.

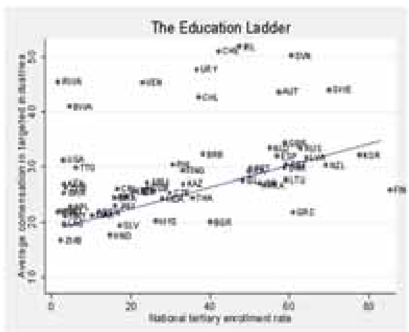
While the targeting strategies of low-wage countries reflect, among other things, their competitive advantage in the attraction of low wage industries, countries with a high average wage display a comparative advantage in high-wage industries. The source of this advantage is, as implied above, their relatively highly skilled workforce. High-wage, high-skill countries are unlikely to be successful in attracting (or retaining) low skill industries, and their target industries reflect this reality. Instead, high wage countries seek to increase the skill level of their workforces and thereby develop a comparative advantage in higher-wage industries. Figure 9 shows the relationship between national skill levels (measured by the proportion of the workforce with any post-secondary qualifications) and the average wage of the IPAs' target industries. Again there is a strong relationship, suggesting that highly skilled countries seek higher wage industries.

**Figure 8. Low wage countries focus on low wage industries**
(Average wage of target industries vs national hourly wage.)




Source: OIR survey. Wage data from ILO. See Appendix 2 for large version.

**Figure 9. Countries with higher skill levels target industries with higher wages**
(Average compensation in target industries vs national rate of tertiary enrolment




Source: OIR survey. Enrolment from World Bank. See Appendix 2 for large version.

*1.5 However, some countries' target industries do not appear to be correlated with the characteristics of the host economy*

Figures 6, 8, and 9 display a clear upward trend, suggesting relationships between the target industries of countries at similar stages of development. However some countries appear to diverge from the curve with their choice of target industries placing them either above or below the trend line in relation to other countries in their peer group.

**Technology:** The two clear exceptions among the low-income countries are Senegal (SEN) and Ethiopia (ETH), whose portfolio of target industries is clearly more optimistic than the rest of the countries in their income group. There are exception among the richer countries is Australia (AUS) whose target industries are lower-tech than other countries in its income class.

**Human capital:** The exceptions among the poor countries are Gambia (GMB) and Rwanda (RWA) in the north-west of the figure, whose target industries have high average wages. The Rwandan investment promotion agency targets food processing, tourism, telecoms, energy, ICT, infrastructure, and finance. The Gambian investment promotion agency targets a similar group of high wage industries. By targeting industries which they arguably do not have the domestic skills and knowledge to support these countries may not be maximising the effectiveness of their promotion efforts.

There is no *a priori* reason to conclude that because these 'off the curve' countries are not following the pattern set by their peers, their targeting strategies must be unsuccessful. However it does give cause for reflection and in a later section of this report we present evidence suggesting that those countries further away from the line of best fit are attracting less FDI than those following the pattern more closely. Hence, countries whose target choices face them 'above the curve' may be over-optimistic in their targeting strategy; those 'below the curve' may be relatively un-ambitious in terms of the level of technology, wage and skills inherent to their target industries.

## How Target Industries are Chosen

*Key Findings:*

***2.0 IPAs use various criteria for choosing target industries. These criteria can generally be characterised as either relating to the attractability of the industry or the desirability of the industry.***

- 2.1 The vast majority of IPAs reported criteria for the selection of targeted industries that amount to an assessment of the relative attractability of FDI from that industry. Examples include the extent to which a country's particular characteristics provided the IPA with a competitive advantage in that industry, and the global mobility of the industry.
- 2.2 Most IPAs also emphasised choice criteria based on the perceived desirability of

potential target industries in the context of general economic objectives. Examples include job creation, and the potential value of the industry to an existing or proposed local cluster.

- 2.3 A small number of IPAs described a portfolio of target industries which were linked to each other in a forward-looking economic development strategy.

*2.1 Most surveyed IPAs target particular industries for two main groups of reasons: their attractability and their desirability*

Countries offered a wide variety of reasons for choosing their target industries. In most cases the choice of industry targets was made autonomously by the IPA in consultation with other government agencies; however in some cases IPAs reported that they were directed to target particular industries by their ministry of treasury or industry.

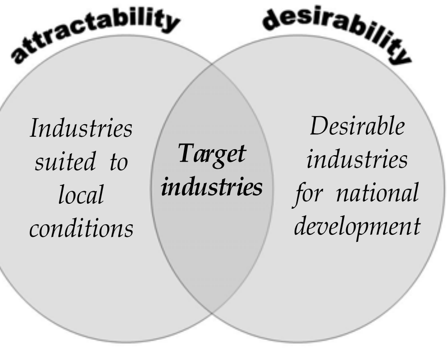
As outlined in detail below, in most cases the selection of targets was based on consideration of the 'attractability' and 'desirability' of potential industries, as illustrated in Figure 10. The attractability of industries is simply a measure of the costs of attracting the industries to a particular location; attractable industries would thus include those that depend largely on the factors of productivity that are cheapest in a given location. For example an abundant local natural resource, say harvestable forests, may be able to be leveraged to attract firms in industries based on wood products. Attractable industries would also include those that are geographically or culturally proximate.

Industries may also be attractable due to their level of mobility on a global scale. Many IPAs currently target industries which are prone to practise the relatively recent phenomenon of business process off-shoring (BPO), where countries relocate low-skill, technical or repetitive business processes to low-wage locations. The high mobility in this area suggests that lower costs are involved in capturing such projects.

On the other hand, desirability refers to the potential benefits and externalities of a given industry. As described in a previous section, not all FDI contributes equally to the local economy. Foreign investment might be particularly sought after if it brings particularly large capital investment, significant employment opportunities, special skills, new production techniques, international networks bringing access to foreign markets, or new capital goods. Industries with a high export propensity were particularly popular, as were hi-tech industries. Other desirable industries might bring particular efficiency benefits to key areas in the local economy, such as the banking sector, or telecommunications, or former state-run utilities.

Figure 10 illustrates a relatively simple method of selecting target industries, being those industries that are both attractable (relatively low cost of attraction) and desirable (relatively high benefits to the host economy).

**Figure 10. A simple target industry selection process**




**Box 1. Factors cited by IPAs in industry and country analysis**

| *Industry attractability factors* | *Industry desirability factors* |
|---|---|
| • Existing size & strength of local industry<br>• Global mobility of industry<br>• Access to domestic or export markets for the industry's product<br>• Natural resources<br>• Availability of required raw materials<br>• Availability of adequately skilled labor<br>• Cost of key inputs (wage rates, energy costs, etc) | • Significant job creation<br>• High wage employment<br>• Industry growth prospects<br>• Potential for technology spillovers<br>• Export propensity<br>• Efficiency benefits<br>• Complementarities with existing local industry clusters and cluster development |

Source: OIR survey responses

Box 1 outlines some of the criteria cited by IPAs when asked why they chose each of their target industries.

The remainder of this section is devoted to explaining those rationales in more detail. IPAs often use more than one targeting method to determine or justify the choice of a target industry. A combination of strategies is both natural and necessary in most cases to ensure that industry targets make sense from a domestic, competitive and global viewpoint.

***2.2 Most IPAs reported criteria for the selection of targeted industries that involve an assessment of the relative attractability of FDI from that industry.***

FDI in certain sectors is easier to attract than others, and targeting these can result in greater inflows of FDI at low promotional cost. If countries possess idiosyncratic competitive advantages which will be of higher value to certain sectors, focusing promotion on those sectors may increase the volume of FDI.

Selecting target industries based on attractability criteria often involves assessing the national strengths of the local economy and determining which industries naturally lend themselves to those qualities.

**Leveraging comparative advantage:** Several IPAs reported that a key criterion for targeting was the identification of industries in which their country had particular advantages over other locations. Using this selection method the IPA identifies aspects of the host country that match the needs of certain sectors, thereby competitively positioning it ahead of other countries.

This approach begins with the characterization of investment generation as a marketing activity based around the variables of product (the advantages and disadvantages of the host as a site for business), price (the search, start-up, fixed and ongoing costs to the investor of doing business in the host country) and promotion (the current image of the host, and the range of available promotional activities that may be used to attract investors)[18].

Through enabling IPAs to isolate key strengths and unique attributes of the host, comparative/competitive advantage enables product differentiation and focused value-added marketing. The IPA leverages advantageous country characteristics (e.g. market proximity and value; business climate; political, civil and technological infrastructures; skills available in the labour force; average wage rates etc) to appeal to investors and market the host-specific value.

**Building on the presence of existing industry roots:** Many IPAs reported that their FDI targeting strategies were partly aimed at capitalising on the strength of existing industries. Industry expansion targeting is a strategy to identify globally competitive industries which have a major domestic presence, and target foreign firms to co-locate.

The existence of an established industry is an important marketing tool for IPAs. It sends a strong signal to foreign firms about the potential of the location. When choosing a location for a new production facility, firms face the challenge of conducting due diligence on each alternative possibility. For example, the firm must determine whether the location has the appropriate skilled labour, raw materials, and networks of suppliers and contractors. It must also make an assessment about the quality of government bureaucracy and the costs of doing business in the country. This information gathering process is imperfect and each project is subject to a range of possible risks. But the existence of an established, successful industry signals to potential entrants that these costs and risks are low.

In addition an existing industry allows IPAs to promote the benefits of agglomeration — the advantages of co-located firms. Firms that locate near each other can reap a range of benefits including those associated with the informal exchange of ideas, and access to a

18) Wells and Wint (2001)

pooled source of skilled employees and shared industry-specific infrastructure.

For these reasons, IPAs may be able to attract new firms based on the advantages provided by an existing industry. By targeting such an industry, the IPA may increase the effectiveness of its promotion and increase the flow of FDI into the domestic economy. However there are several drawbacks associated with focusing investment promotion resources on industries in which the country already has established capabilities. First, where foreign activity is already well-established in a domestic industry, the cost of further promotion may represent a sub-optimal use of resources, since the success of the industry will attract further FDI anyway. Second, further FDI in the industry, despite being relatively easy at attract, may actually be a lower priority with regard to economic development than the establishment of new industries. Existing industries may have lower growth potential than newer activities with greater growth potential. In the case of countries like Botswana, diversification of the domestic economy away from the mining sector has been an important development goal for their development agencies, and their national IPA, BEDIA.

Jamaica's IPA, JAMPRO, used comparative advantage analysis to determine which existing sectors in Jamaica are the most globally competitive in terms of domestic growth and global potential, then developed individual marketing strategies for each. The chosen industries, tourism (including hotels and attractions) and entertainment (film and music), were analysed on a detailed level for expansion opportunities to specific demographics, leading to targeted marketing strategies for these sectors.

**Targeting Mobile Industries:** This strategy attempts to increase the inflow of FDI by focusing on industries which demonstrate high world flows. For example CzechInvest, like many IPAs, continually monitors new investment projects in Europe. It performs a target review every 2 years, and uses industry-specific project data to identify the most fluid industries. CzechInvest targets these mobile growth sectors to increase their FDI flows. Similarly Costa Rica's IPA, CINDE, uses current industry data to determine high-growth sectors for targeting the following year. Individual targets are selected on the basis of their performance within these sectors.

Flow data can help point an IPA towards industries which are relatively easier to attract due to heightened relocation activity. However this does not appear to have any bearing on their value to the host economy, and as such IPAs should not rely on flow data alone to determine targets. In addition, without careful interpretation, flow data can be misleading as a measure of industry strength. Extreme fluctuations from year-to-year are common, and industry figures can be skewed by factors such as the presence of large M&As.

### *2.3 Most IPAs also emphasised industry choice criteria reflecting the desirability of potential target industries'*

Not all FDI contributes equally to the local economy. Foreign investment might be particularly sought after if it brings special skills, new production techniques, international networks, access to foreign markets, or new capital goods. It is no surprise that IPAs choose to target industries in which the potential realisation of these benefits is greatest. As shown in the previous section of this paper, industries with high wages and high technology were particularly popular targets among the countries in our sample. Other desirable industries might bring particular efficiency benefits to key areas in the local economy, such as the banking sector, or telecommunications, or former state-run utilities. FDI in certain sectors will (depending on the individual characteristics of the host country) be more beneficial for the long-term economic or social development of a country than FDI in other sectors, therefore represent investment of higher value to the country.

**Cluster development targeting**: Cluster development targeting is a related strategy which also attempts to build on existing capabilities in the host country. However instead of seeking to attract a group of similar firms, this approach is based on expanding an industry into a related cluster of industries and selectively seeking investment to fill gaps in supply chains. IPAs seek foreign firms to capitalise on cluster opportunities such as new linkages and upgrading support industries. Sean Dorgan, one time CEO of the Irish Development Agency described the objective of the IDA as "to help create clusters of excellence in Ireland in which technology companies, education and research activity, venture capital providers and so on, network to create superb innovation and entrepreneurship."[19)]

Following an analysis of its existing industries, the Botswana investment promotion agency, BEDIA, realized that the domestic beef industry in Botswana was unaccompanied by associated industries which used the by-products of beef slaughtering and preparation. A surplus of raw hides in the domestic marketplace led to a feasibility study being commissioned by BEDIA to determine whether there was potential for the development of the tannery industry. Having received a positive report from the independent consultants who performed the study, BEDIA are now looking for foreign investors to set up a tannery and to develop a cluster of industries around beef production.

Recognising that it could not excel across all industries, the Costa Rican IPA, CINDE, decided in the 1980s to focus its resources on attracting electronics manufacturing firms. After it had begun to build a successful electronics cluster, it branched out to two different,

19) IDA (2003), "IDA Ireland ranked as best overall managed Investment Promotion Agency (IPA) in Europe" 13-Mar-2003, http://www.idaireland.com/news/show Release.asp?storyid=189

but related industries: medical technologies and business services.

Proponents of cluster-theory argue that the development of clusters improves competitiveness and therefore improves productivity through: improved access to specialized suppliers, skills and information; closer linkages of firms seeking to improve the processes of production; and the tendency of clusters, once established, to expand through the creation of new firms and the entrance of new suppliers.

**Potential/Capability targeting**: Potential/Capability targeting is a more sophisticated targeting technique whereby industries are analysed based on their domestic potential v existing domestic capabilities to find a 'sweet spot' for identifying key development goals.

New Zealand's IPA, Investment New Zealand, used a potential/ capability matrix to measure domestic potential as a combination of the industry's desirability from a global perspective and its alignment with domestic characteristics (primarily in terms of comparative advantage). Domestic capability was measured by looking at domestic market size relative to global market size, cluster development, and sector innovation. The result was the identification that four industries warranted strategic targeting: biotechnology, ICT, creative industries and environmental technologies, and a further 6 industries that warranted 'tactical' targeting.

**Economic Development targeting**: Economic development targeting focuses on identifying the set of industries which are expected to contribute the greatest value to the host economy's development over both the short- and long-term.

Chile's IPA, the Foreign Investment Committee, is typical of many centrally governed promotion agencies, and follows a development plan produced in collaboration with the Chilean Development Agency (CORFO) and the Ministry of Economy. It is currently targeting mutual funds, ICT, public works, biotechnology, health services and agribusiness, these having been judged by the government to be the most likely to contribute to economic development.

For example some IPAs focus on industries with particularly desirable characteristics, such as employment creation potential, or high technology. Brazil's IPA, InvesteBrasil, seeks to target projects which will result in job-creation, produce items for export, and employ high tech processes with transfer opportunities. While it tries to fit in with the Brazilian government's development priorities, InvesteBrasil is not dictated by these, acting instead as a one-stop-shop to attract the highest possible yield of regional FDI.

As many commentators have pointed out, the value of FDI lies almost wholly in its ability to contribute to economic development. Targeting strategies should therefore contain at their core the goal of efficiently attracting economically beneficial FDI. However all targeting strategies must take into account the time factors required for development.

History has shown that developing economies cannot sustain industrial development without considerable existing infrastructure, and even then may be susceptible to market movements and currency speculation. Additionally, IPAs need an accurate measurement of which industries represent economic development value to their country. For example, while auto-manufacturers have been traditionally considered highly desirable as investors, the experiences of Brazil in 1999[20] demonstrate that even these projects can result in a net loss to an economy, especially when coupled with the use of fiscal and financial incentives. With a coherent and rational plan for leading economic development over time, and with firm knowledge of which industries represent real value for the host, targeting for development will theoretically result in the highest net gain from FDI. However such an approach is not a simple task, and will often employ many of the other strategies outlined in this paper to ensure both correct industry identification over the medium- to long- term and to maximize efficiency of attraction.

### *2.3 The criteria of attractability and desirability can be combined into a coherent portfolio of target industries*

For the IPAs, the choice of target industries may involve a trade-off between their two key objectives: increasing the flow of foreign investment and contributing to national development. The source of the trade-off lies in the fact that some industries are easier to attract, while other industries can contribute more to national development. When selecting target industries, should IPAs choose industries that are most likely to increase the volume of foreign investment (i.e. the easiest to attract), or that are most likely to contribute to economic development (i.e. those with some desirable quality like R&D intensity, high export propensity, high wages, etc), or some combination of these and other criteria?

Our survey found considerable variation in the motivating factors for IPAs to choose specific target industries. The results show great variation in targeting choices, methods and rationales. Most interestingly we found that many IPAs lacked a targeting strategy that enabled a clear prioritization of targets. Most IPAs expressed impressive rationales for their targeting choices and could state clear reasons for choosing each of their target industries. However few IPAs expressed an overall targeting framework that enabled them to choose between potential target industries and manage the inherent trade-offs in such a choice.

An overall targeting framework involves a forward looking choice between the promotion of existing industries and the long term needs of industries of the future. The experiences of Malaysia, Singapore, Ireland, and more recently, Chile and the Czech Republic demonstrate that a clearly defined national targeting strategy can play a central role in industrial progress. By contrast, a strategy which is piecemeal, ad hoc, or not closely

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20) Oman (2000)

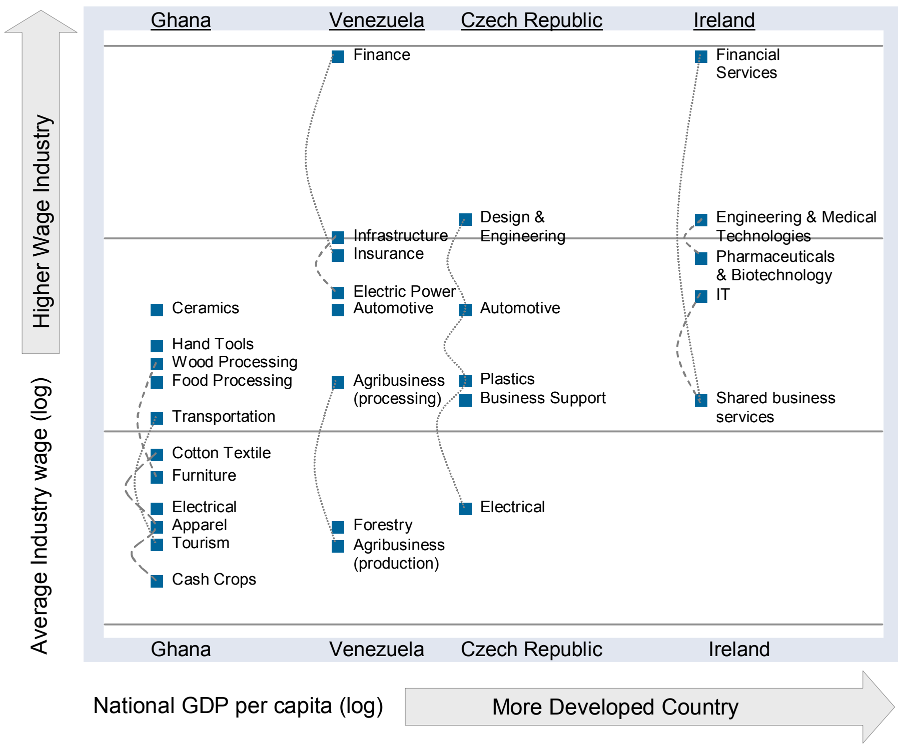
integrated into broader national development programs can miss opportunities to contribute to national development and hence waste promotion resources.

One strategy involves finding a connection between attractable industries in the short-run and desirable industries in the long-run. A key element of this type of strategy is the identification of 'pathway industries'. Pathway industries are attractable industries (although not necessarily the most desirable) that ultimately allow for sustainable economic development and growth by serving as the stepping stones to desirable industries of the future. They lay the foundation for those industries by training the local labour force with some of the key skills required by the goal industry; or by creating a network of firms capable of supplying key inputs to the goal industry.

Figure 11 shows the target industries of four investment promotion agencies (Ghana, Venezuela, Czech Republic, and Ireland). Each country is plotted on the horizontal axis according to its national GDP per capita (the richest country, Ireland, is on the right). Each industry is plotted on the vertical axis according to its average wage (measured as the average wage paid by the foreign subsidiaries of U.S. firms in each industry).[21] Notice initially that, as we expect, higher GDP per capita countries target a portfolio of industries with, on average, higher wage rates.

**Figure 11. Coherent Targeting Strategies**

The targeting industries of four sample countries




21) These data come from the U.S. Bureau of Economic Analysis which reports the compensation paid to workers in all foreign subsidiaries of US parent firms. Wage data are reported by industry.

Importantly the target industries chosen by these four sample countries appear to be linked in several ways. For example, the Czech Republic's IPA, CzechInvest, targets (in ascending order of average wage rate) electrical, plastics, automotive, and design-engineering industries. These industries are linked and interdependent through the skills they require of their labour forces and inputs and outputs they produce.

A strategy similar to the one outlined above can play a major role in developing new industries. Using a strategy of pathway industries can simultaneously increase the volume of FDI and contribute to development. Pathway industries are easy to attract and they lead to the development of desirable industries. The figure below provides an illustration of this strategy which can be broken down into three steps illustrated in Figure 13.

**Step 1:** Conduct country/industry analysis to determine desirable industries for long term growth and development. This involves analysing long-term industry trends (growth, quality of employment opportunities, export potential, stability in this location) to create a list of desirable industries. Those industries that are desirable and currently attractable are 'national strength' industries (Quadrant I, Figure 12) that may already exist or be immediately targeted for FDI.

**Step 2:** Conduct country/industry analysis to determine attractable industries for long term growth and development which may not be currently attractable. To up-skill the economy and create new industries of the future, FDI policy may also develop a long term focus on those industries which are desirable but not immediately attractable given current national conditions (Quadrant 2, Figure 12). Attracting these firms requires building national comparative advantage

**Step 3:** Build national comparative advantage by attracting 'pathway industries' from Quadrant 3 (Figure 12). These 'quick win' industries are easier to attract than future goal industries, but less desirable in the long-term. The long-term advantage of pathway industries' lies in their role in building dynamic comparative advantage in key areas that increase the capability of the domestic economy to attract future goal industries.

The task of identifying national strengths, future goals and pathway industries is not a simple task, and one that often involves considerable expertise in industry analysis. IPA interviews showed that many IPAs engage specialist location consultants such as IBM Plant Location International or strategy consultants such as the Boston Consulting Group to aid them in choosing industries which have a high potential or represent considerable

**Figure 12. Target Industry Motivation Matrix**

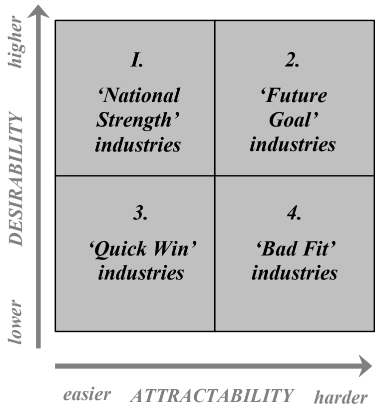
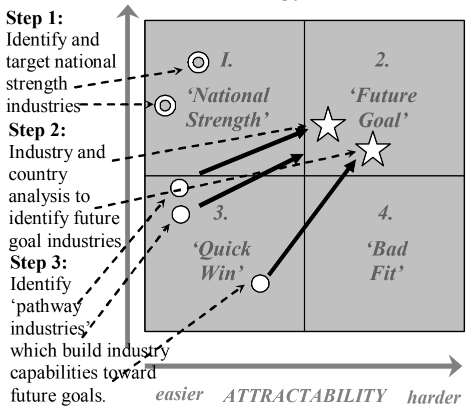



**Figure 13. Dynamic Targeting Strategy**




comparative advantage. For example, Italy's new national agency responsible for investment promotion, Sviluppo Italia, is currently choosing its new target sectors based on in-depth analysis by a team of external consultants, and plans to restructure its investment

### Box 2: Micro strategies and other factors relevant to targeting choices

As well as selecting target industries, IPAs may seek to refine their choices by choosing subsets of industries or particular firms within industries based upon other relevant criteria. Many IPAs use these tactics to isolate the most valuable target firms in the most efficient manner.

*Executive ex-pat targeting*
Executive ex-pat targeting concentrates on industries and firms where ex-pats hold key management positions, leveraging the influence of ex-patriot executives in foreign MNCs to encourage their employers to invest in the host country. TIDCO, the IPA for Trinidad & Tobago, leverages the contacts of Trinidadians living abroad, offering them incentives to help the agency get into board rooms and promote Trinidad as a site for investment.

*Country targeting*
Country targeting approaches the problem of resource focus from a geographical perspective, often concentrating resources in strategic proximity to potential sources of FDI inflows. Japan's national IPA, JETRO, says that it determined its target industries (ICT, biotechnology, medical care & environment) were determined by "past experience" and are not likely to change. Instead, its targeting strategy focuses on placing regional resources in key geographic locations. Regional offices such as NY and London were chose due to their role as financial centres, hubs for executive travel, and the presence of large numbers of TNC head offices.
Country targeting, like industry targeting, is essentially a question of promotional efficiency. Most IPAs reported that they focused on neighbouring countries. Non-neighbours targeted locations were strongly concentrated in a handful of large North American and European cities. This in turn means that competition for FDI projects is far greater in these popular centres.

*Existing-investment expansion targeting*
Existing-investment expansion seeks to leverage contacts with existing foreign investors to expand their investment, and hence the net value to the host economy. New Zealand's IPA, Investment New Zealand, holds regular meetings with executives at the head office of existing foreign investors, as an after-care service but also to promote the advantages of further capital investment and expansion of existing projects in New Zealand. This form of expansion targeting is run by regional representatives of Investment New Zealand, and forms a major part of their regional targeting strategy.

*Ready project targeting*
Ready-project targeting is a highly-refined form of comparative/competitive advantage targeting. This strategy identifies lucrative investment opportunities that can be pre-prepared by undertaking feasibility studies and project-planning, then presenting potential investors in the relevant industry with pre-approved, fast-track projects. Jamaica's IPA, JAMPRO has recently been targeting specific hotel operators which it thinks may wish to invest in new hotels along Jamaica's tropical coastline. To gain a competitive edge over other IPAs, JAMPRO has developed a 'ready-project' targeting strategy, whereby it pre-plans and obtains initial government approval for certain projects, such as mid-sized hotel buildings and associated infrastructure. It then presents target operators with the pre-planned projects, including site details, approval certificates and feasibility studies. This tactic has reportedly had a success-rate. This strategy attempts to enhance the attractiveness of a stand-out project in an already-chosen target industry, and requires a high degree of knowledge and planning concerning what will appeal to investors. By absorbing much of the initial cost in site-selection and planning/approval, the IPA takes on an equivalent level of risk that such a project will not proceed, rendering the lead-up process a waste of resources. The attraction of such a strategy is that, for investors, a pre-planned project has a known (and hence lessened) risk exposure. Moreover, the existence of feasibility reports and cost-projections allows for a more focused and professional promotion process.

generation activities by sub-sector once these have been finalised.

The dynamic targeting strategy depicted in figure 13 allows an IPA to choose between and prioritise a set of industries that have been identified according to traditional target-choice methodologies based upon desirability and attractability. This in turn results in a coherent targeting strategy that enables the integration of a forward-looking economic development plan with a portfolio of realistic target industries for FDI promotion.

## Does Targeting Work?

*Key Findings:*

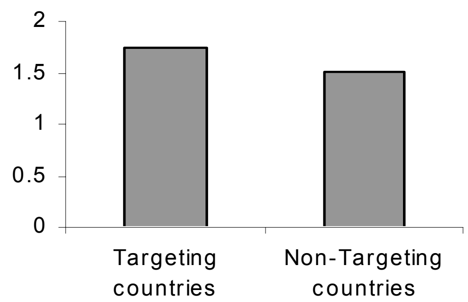
***3. Whether a country conducts industry targeting, and which industries it chooses, appear to affect its FDI***

- 3.1 Measured in terms of smoothed FDI/GDP data over a seven-year period (1995-2002), surveyed countries that do practice industry targeting attract more FDI than those that do not target industries.
- 3.2 Countries whose target industries that are not aligned with their national characteristics attract less FDI.

*3.1 Targeting countries attract more FDI*

Our survey presents evidence that targeting countries are more successful in attracting FDI than countries without targeting strategies.

**Figure 14. Targeting countries attract more FDI**
(FDI success index derived from ration of FDI/GDP)




Note: To remove volatility FDI as a % of GDP is measured as the (negative) square root of the (negative) ratio of FDI to GDP averaged over the years 1995-2002.
Source: FDI data from World Bank.

We measure FDI success as the size *and* stability of the ratio of FDI inflows to GDP for each country. Data on FDI inflows are often not reliable measures of the real impact of FDI since large year on year changes can be affected by single transactions such as large scale government privatisation programs or large M&A transactions. To remove some of the effect of these large transactions we measure FDI success over a seven year period between 1995 and 2002. We also eliminate volatility by taking the average of the square root of the ratio of FDI to GDP.[22] This filters out abnormally large annual figures and delivers an index of FDI success which measures both the size and stability of FDI flows.

Figure 14 shows that countries which actively target specific industries have been more successful in attracting FDI over the period. This difference is, however, only marginally significant at the 15 per cent level.

It should be pointed out that calculating the difference in FDI performance between targeting and non-targeting countries is a difficult task. Firstly, there are statistical hindrances. As mentioned above, the quality of FDI data is sometimes questionable and prone to spikiness, and we have attempted to correct for this by using smoothed data. Secondly, using the ratio of FDI to GDP corrects for the fact that countries with larger GDPs tend to attract larger FDI flows. However these methods do not allow us to allow for variables related to the size of IPA budgets in the two groups of countries, data which is not yet available across the entire sample of national IPAs.

Nevertheless, the survey data does indicate there is an increase in FDI for countries that target. This suggests that, on average, investor targeting results in increases in FDI inflows. Further research and more detailed analyses are being conducted by Oxford Investment Research to estimate the multiplier effect of industry targeting upon FDI inflows, in both cross-country and cross-industry studies.

### *3.2 Countries whose target industries that are not aligned with their national characteristics attract less FDI*

It was noted above that countries tend to target industries which align with their national characteristics. Figure 6 showed that the technology level of the average targeted industry was closely related to each country's national development, measured as its GDP per capita. Similarly, figure 8 showed that the average wage in the average targeted industry followed a similar pattern. While most countries followed a steady upward trend, there are a several countries who sit apart from others in their income group. In the wage diagram (figure 8) Gambia (GMB) and Rwanda (RWA) appear to be clearly more ambitious in their targets than their peers, while Greece (GRC), Algeria (DZA), Pakistan (PAK), and others appear to be clearly less ambitious.

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22) If the inflow is negative, we take the negative of the negative of the square root.

Analysis of survey data presents some evidence that these 'off the curve' countries perform less well in attracting FDI. Our analysis sought to determine whether a country's distance from the trend-line in figure 8 could be related to FDI performance. Use of a regression model (Table 1) demonstrates that countries further away from the trend line tend to perform worse than those countries closer to the trend line.

**Table 1. Regression results**

This table shows a negative relationship between the distance of each countries targeting strategy from its peer group (WAGE DEV) and its net FDI. This table shows regression results for the relationship between FDI flows and three independent regressors: the wealth of the country (GDP per capita), the size of its economy (GDP), and the difference between the wage in its target industries and the wage implied by its level of development.

| Dependent Var: | Net FDI/GDP 1995-2002 | | |
|---|---|---|---|
| | Coef. | T value | P value |
| GDP per capita (log) | 0.33 | 4.04 | 0.00 |
| GDP (log) | -0.17 | -3.00 | 0.00 |
| WAGE DEV | -0.04 | -1.89 | 0.06 |
| Constant | 2.77 | 2.51 | 0.01 |
| No of obs. | 77 | | |
| R-squared | 0.20 | | |

The analysis regressed the average wage in target industries for each country on its wealth (log level of GDP per capita) and the size of its economy (log GDP). This gave us a linear relationship with which to predict a fitted value for each country's target industry wage. We calculated the difference between this fitted value and the actual value of the average wage in each country's target industries — in figures 6, 8, and 9 this difference is analogous to the vertical distance between each point and the trend line — which is a measure of how far each countries target industries diverge from those implied by their wealth and size. We compared the absolute value of this divergence to the FDI flows for each country over the period 1995-2002.

We found that countries which diverged more from the average ('off the curve' countries) attracted less FDI than those closer to the average ('on the curve'). Table 1 shows the regression results in detail. The independent variable is the ratio of net FDI inflows to GDP over the eight-year period, while the dependent variables are the countries wealth (GDP per capita), size (GDP) and the deviation of the average wage in targeted industries from the fitted value (WAGE DEV). The coefficient on the deviation term is negative and significant, suggesting that the larger the absolute deviation, the lower the level of attracted FDI.

The analysis above indicates that the relationship depicted in figure 8 between national characteristics and IPA targets appears to maximise the level of FDI attracted by countries. The regression shows this by indicating that the further countries are from the line of best fit in figure 8, the lower the FDI they attract. This does not necessarily mean that all countries with similar characteristics should target the same industries. It does suggest, however, that IPAs should take into account the average wage in their target industries when choosing targets.

The results in this section suggest that targeting countries, and in particular those that choose target industries in line with economic development, attract more FDI than non-targeting countries. While this result clearly emerges from the data, it is important to stress the obvious caveat: there are many factors other than investment promotion that affect FDI flows. Moreover our analysis does not address the quality of the FDI attracted. Such questions require more detailed data and are left for future investigations.

## Conclusion

### *4.0 Extending the findings of this paper for IPA function*

- 4.1 Industry targeting is widespread, competitive, and usually a function of a country's current degree of industrialization.
- 4.2 IPAs use various criteria when choosing target industries. These criteria can generally be characterised as either relating to the attractability of the industry or the desirability of the industry
- 4.3 Whether a country targets, and which industries it chooses, appears to affect its FDI. Industry targeting is linked to increased FDI inflows, and diverging from targeting trends with regard to increasing wage levels may have a negative impact on a country's ability to attract FDI
- 4.4 There are many aspects of industry targeting that require further research, including many issues that should be addressed to ensure that the endeavours of IPAs are not undervalued.

### *4.1 Industry targeting is widespread, competitive, and usually a function of a country's current degree of industrialization.*

Over 70% of our sample reported a form of industry targeting. Targeting is more prevalent among smaller and richer countries, and, in general, industry targets follow a trend whereby the technology, wage and skill levels inherent within target industries rise with the development level of the country. Electronics and electrical equipment, information and communications technology, and food related products are the most commonly targeted industries.

The survey results clearly show that industry targeting is a key function for IPAs.

Interviews with selected IPA executives showed that many IPAs are structured according to target industries, with industry experts employed to design targeted programmes and manage engagement with potential investors. Being a method of selecting industries for specialised investment generation, activities associates with industry targeting are expensive; however over 90% of interviewed executives indicated that despite the expense associated with targeted promotion, industry targeting was a core component of their investment promotion efforts.

More interestingly, the survey demonstrates that IPA target choices follow patterns based on the average technology, wage and skill levels of targets. The fact that target choices are linked to industrialisation implies that consideration of these three characteristics is an important factor in evaluating an overall targeting strategy. This is further demonstrated in section 3.2, where a regression of the wage ladder found that divergence from prevailing trends with regard to the average wage within industry targets may affect FDI inflows.

***4.2 IPAs use various criteria when choosing target industries. These criteria can generally be characterised as either relating to the attractability of the industry or the desirability of the industry.***

Our survey reveals that targeting is performed for many reasons. Justifications given by IPA executives included the need to capture efficiency gains, carefully distribute scarce resources, capitalise upon comparative advantage inherent in country characteristics, meet the demands of investors, integrate their activities with other industrial development agencies, and meet 'best-practice' guidelines in FDI attraction.

The survey revealed broad variation in the methodologies employed by IPAs to choose target industries. These methodologies fall broadly into two categories: those relating to the attractability of the industry, and those relating to the desirability of the industry. IPAs often employed more than one method of choosing industry targets.

The survey did not attempt to judge the effectiveness of individual target-choice methodologies, as that is a task best left for a separate paper. However it is clearly evident that the variation in methodologies is matched with variation in the sophistication of the target-choice methods. A significant number of countries employed consultants to conduct in-depth industry analysis and sub-sector feasibility studies in order to assess their suitability for targeting, while others made targeting decisions based purely on FDI flow data, or average cross-industry job creation. For some IPAs, their ability to independently choose targets was limited by the need to adopt development goals in collaboration with (or set by) other government agencies.

The importance of industry targeting implies a correlated significance in developing a real targeting strategy, rather than merely compiling a list of desirable industries for investor targeting. However a considerable number of IPA executives reported that the IPA targets were based upon achieving short term employment or FDI flow goals, with no linkage to economic development or consideration of other flow-on effects provided by different industries.

Consideration of the broad range of methodologies led us to consider that choosing target industries based upon desirability or attractability alone is theoretically sub-optimal. Ignoring elements of one or both is to neglect an important justification of targeting itself — maximising resources to capture high-value projects in order to ultimately enhance economic development. Observation of the targeting methodologies employed by anecdotally successful IPAs led us to develop the matrix-based model of targeting displayed in figures 12 and 13. Here, attractable 'pathway' industries are identified and targeted in order to build capacity to eventually attract highly-desirable 'future goal' industries. Such a dynamic targeting strategy enables short-term FDI attraction goals to mesh with long-term development goals.

*4.3 Whether a country targets, and which industries it chooses, appears to affect its FDI. Industry targeting is linked to increased FDI inflows, and diverging from targeting trends with regard to increasing wage levels may have a negative impact on a country's ability to attract FDI.*

Analysis of survey data shows that targeting is linked to changes in FDI, with a marginally significant increase in FDI for countries that target. This suggests that, on average, investor targeting results in increased FDI inflows. Further research is being conducted by Oxford Investment Research to investigate the link between targeting and FDI in more detail.

Interestingly, as mentioned above, regression analysis of figure 8 showed a negative impact on FDI inflows for those countries that diverged from targeting trends with regard to increasing wage levels. Those countries that targeted a set of industries with average wage levels above or below the trend-line displayed lower FDI inflows. This suggests that targeting a set of industries with wage characteristics in line with the country's level of development and existing wage levels is a key factor in attracting FDI.

*4.4 There are many aspects of industry targeting that require further research, including many issues that should be addressed to ensure that the endeavours of IPAs are not undervalued.*

This paper presents the results of a survey of 122 IPAs regarding their industry targeting practices, and has produced a number of interesting and important facts about the way that IPAs conduct industry targeting on an individual and group level.

However there remain many questions and issues which are of great importance and relevance to IPAs and their efforts to capture ever-increasing flows of FDI.

- ***Is targeting effective?***

A crucial question for IPAs is whether industry targeting represents an effective method of generating inward investment. While this paper concludes on the basis of the data reviewed that targeting is effective, more research is needed to qualify this and to add further to our knowledge of how targeting contributes to FDI inflows.

To this end a current project by Oxford Investment Research attempts to discern a connection between targeting and FDI inflows by analyzing cross-industry time-series FDI data for a set of 22 OECD countries. This paper will look for variation in FDI flows between target and non-target industries by examining data on either side of when targeting began for various industries.

- ***Is there a demonstrably optimal targeting methodology for countries at various stages of economic development?***

Figures 12 and 13 propose and demonstrate a dynamic targeting strategy to enable IPAs to link short-term 'attractable' industry targets to long-term 'desirable' goals. However designing a coherent targeting strategy involves considerable analysis from domestic and global perspectives. Finding ways to efficiently collect and analyse the wealth of data available through a variety of sources presents a challenge to all IPAs, especially those with budgets that do not allow for the outsourcing of strategic functions.

Oxford Investment Research is currently investigating and evaluating key criteria for judging industry potential and existing strength in terms at the domestic and international level. Ultimately, we hope to produce a testable framework for choosing appropriate industry targets for countries at various stages of economic development.

- ***On what grounds can the success of a targeting strategy be judged?***

The issue of performance measurement has been long identified as a crucial one for judging the success or failure of IPA activities.[23] IPAs reported that their success measures (and hence budgets) are most often tied to FDI flow data and the number of jobs 'created' by FDI projects. Both of these measures are, however, sub-optimal in terms of measuring the success of an IPA. FDI flow data, as stated above, is prone to gross fluctuations

23) Wells and Wint (2001)

through the influence of large M&As and global trends, while job creation may not always be the most effective measure of economic benefit for three reasons: job 'creation' is initially often merely a transfer of skilled labour from other industries rather than a net increase in the number of employed persons in the economy; many of the most desirable industries bring high capital-labour ratios (meaning their economic value could be far in excess of the observed job creation); and some projects will cause flow-on effects that include the creation of jobs not directly tied to the project.

Oxford Investment Research is managing a project to develop project evaluation tools and success measures to enable IPAs to assess the individual and total value of their attraction efforts. We envisage these tools being particularly useful when combined with industry analysis to determine optimal industry targets.

Efforts to refine and improve IPA function and efficiency continue at many levels. International institutions and organizations such as the OECD, the World Bank, UNCTAD and WAIPA seek to help governments and their IPAs around the world enhance their attraction of FDI to the ultimate benefit of economic development. This paper on industry targeting aids these endeavours by adding to the sum of IPA knowledge on industry targeting practice and theory.

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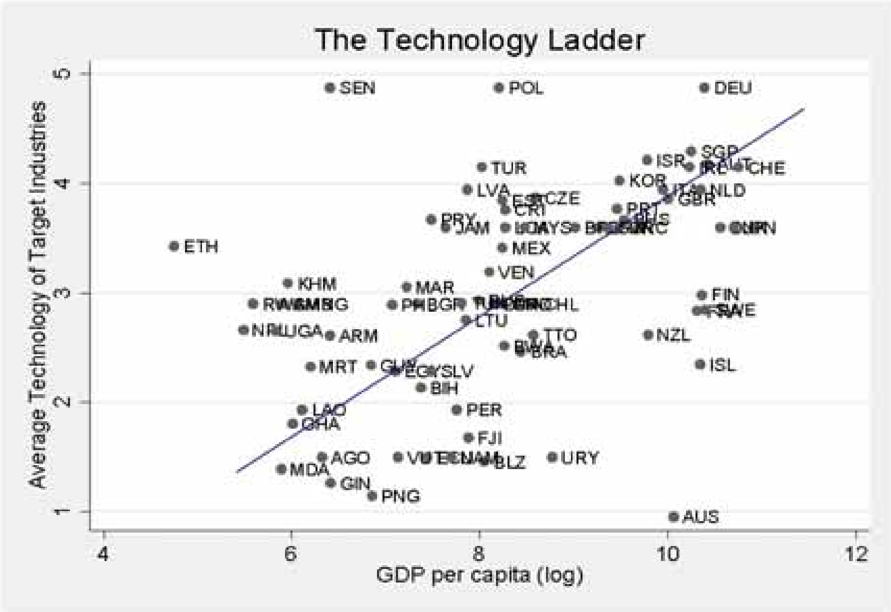
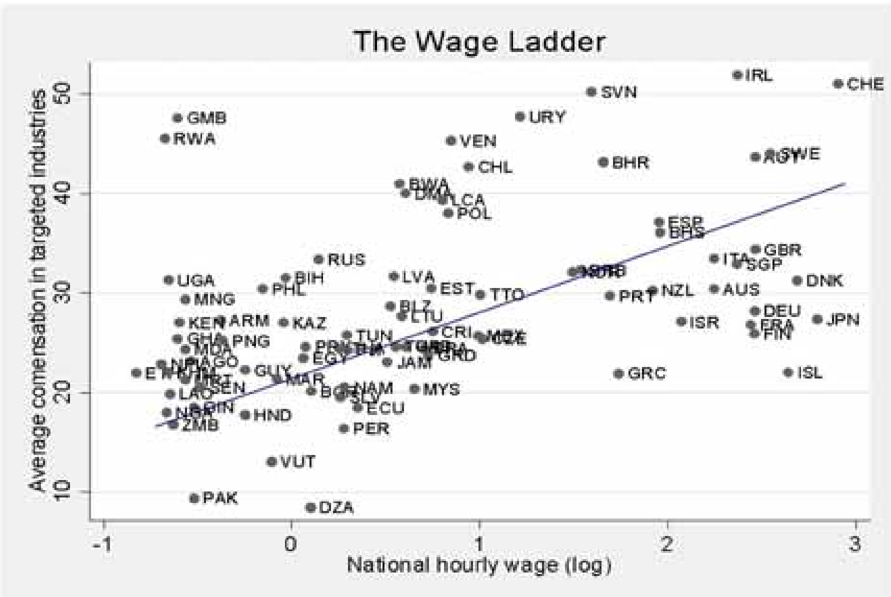
## Appendix: Enlarged Figures

**Figure 6. More developed countries target higher-tech industries**
(Average technology index in target industries vs GDP per capita)



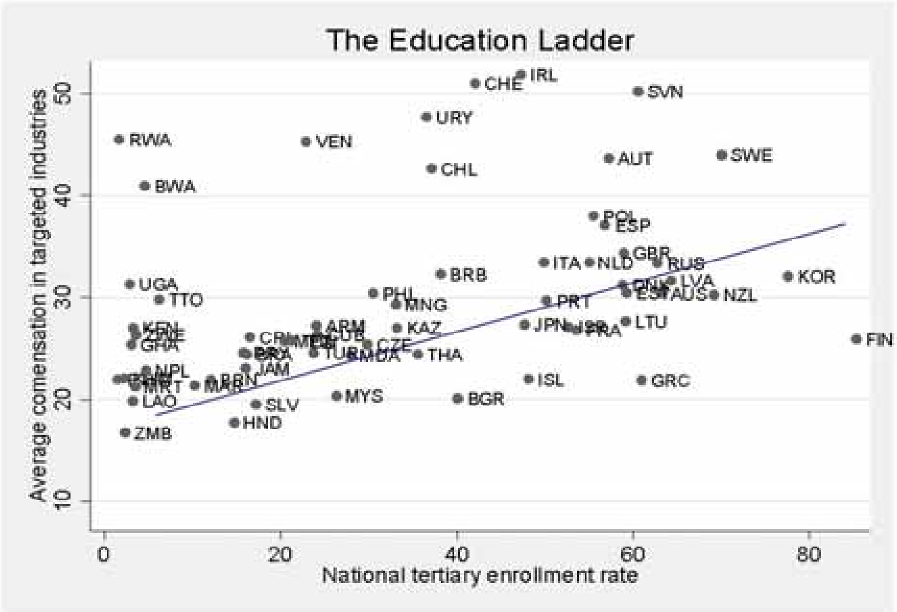

Source: OIR survey. GDP data from World Bank.

**Figure 8: Low wage countries focus on low wage industries**
(Average wage of target industries vs national hourly wage.)




Source: OIR survey. GDP data from World Bank.

**Figure 9. Countries with higher skill levels target industries with higher wages**
(Average compensation in target industries vs national rate of tertiary enrolment




Source: OIR survey. GDP data from World Bank.

## Appendix: Country Codes

The following table displays the 3-digit country-codes used in figures 6, 8 and 9. In the final form of this paper these will be incorporated into Appendix 1.

| Country | Code | Country | Code | Country | Code |
|---|---|---|---|---|---|
| Algeria | DZA | Grenada | GRD | Niger | NER |
| Angola | AGO | Guam | GUM | Nigeria | NGA |
| Argentina | ARG | Guatemala | GTM | Oman | OMN |
| Armenia | ARM | Guinea | GIN | Pakistan | PAK |
| Australia | AUS | Guyana | GUY | Palestine | PSE |
| Austria | AUT | Honduras | HND | Papua New Guinea | PNG |
| Azerbaijan | AZE | Hungary | HUN | Paraguay | PRY |
| Bahamas | BHS | Iceland | ISL | Peru | PER |
| Bahrain | BHR | India | IND | Philippines | PHL |
| Barbados | BRB | Indonesia | IDN | Poland | POL |
| Belgium | BEL | Iran | IRN | Portugal | PRT |
| Belize | BLZ | Ireland | IRL | Reunion | REU |
| Bolivia | BOL | Israel | ISR | Romania | ROU |
| Bosnia & Herzegovina | BIH | Italy | ITA | Russia | RUS |
| Botswana | BWA | Jamaica | JAM | Rwanda | RWA |
| Brazil | BRA | Japan | JPN | Saudi Arabia | SAU |
| Brunei Darussalam | BRN | Jordan | JOR | Senegal | SEN |
| Bulgaria | BGR | Kazakhstan | KAZ | Seychelles | SYC |
| Cambodia | KHM | Kenya | KEN | Singapore | SGP |
| Chile | CHL | Korea | KOR | Slovak Republic | SVK |
| Cook Islands | COK | Kuwait | KWT | Slovenia | SVN |
| Costa Rica | CRI | Lao | LAO | Solomon Islands | SLB |
| Cuba | CUB | Latvia | LVA | Spain | ESP |
| Cyprus | CYP | Lebanon | LBN | St Kitts and Nevis | KNS |
| Czech Republic | CZE | Lesotho | LSO | St Lucia | LCA |
| Congo, Democratic Republic of | COD | Lithuania | LTU | Sweden | SWE |
| Denmark | DNK | Malaysia | MYS | Switzerland | CHE |
| Dominica | DMA | Mali | MLI | Tahiti, French Polynesia | PYF |
| Ecuador | ECU | Malta | MLT | Thailand | THA |
| Egypt | EGY | Mauritius | MRT | Trinidad & Tobago | TTO |
| El Salvador | SLV | Mexico | MEX | Tunisia | TUN |
| Estonia | EST | Micronesia | FSM | Turkey | TUR |
| Ethiopia | ETH | Moldova | MDA | Uganda | UGA |
| Fiji | FJI | Mongolia | MNG | United Kingdom | GBR |
| Finland | FIN | Morocco | MAR | Uruguay | URY |
| France | FRA | Mozambique | MOZ | Vanuatu | VUT |
| Gabon | GAB | Namibia | NAM | Venezuela | VEN |
| Gambia | GMB | Nepal | NPL | Yemen | YEM |
| Germany | DEU | Netherlands | NLD | Zambia | ZMB |
| Ghana | GHA | New Zealand | NZL | Zimbabwe | ZWE |
| Greece | GRC | Nicaragua | NIC | | |

# Session 2: The Trade & Investment Policy Nexus: Current Status in the DDA Negotiations

**Presentations**

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Mr. Bijit Bora, Counselor, Economic Research and Statistics Division, WTO

# The Trade & Investment Policy Nexus: Current Status in the DDA Negotiations

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Thank you, Taeho Bark, for your kind introduction. I want to remind Taeho that I spent a very lovely semester at his invitation in 1997 as a visiting professor at Seoul National University just before the Financial Crisis. . What I want also to remind Taeho is that we appeared together on Arirang Television, along with Oh Jong Nam who is now Executive Director of Korea for the IMF. Our discussion centered on why Korea would benefit from participating in the Multilateral Agreement on Investment (MAI). At that time the assumption was that the MAI would be successfully negotiated at the OECD, Korea would join it and that there would be potential benefits to Korea from doing so. Of course, none of that happened, and investment issues remain less than fully covered by multilateral agreements, as Bijit Bora has reminded us in his presentation. The question is, then, what still needs to be done?

This morning we have in fact heard quite a lot about how foreign direct investment has started to grow again after some years of decline, the decline occurring after the year 2000, which was an all-time peak for foreign direct investment. While the current growth is all well and good, what I would like to observe is that some rather disturbing developments have occurred in quite recent times that might shed some aspersion as to whether or not that growth will continue. Thus, there are some issues on the horizon that, at least for those of use think that foreign direct investment by and large is a good thing, are bit worrying. I will put as number one on my list of such issues a rise in nationalist reactions to foreign direct investments, where these reactions are occurring in major countries. Maybe the first example to cite is the absolute furor that was created by the efforts of the Chinese National Overseas Oil Corporation (CNOOC) this last summer to bid for a US oil firm, Unocal. Unocal is in fact a rather a minor oil producer, and it is even now, several months after the CNOOC bid was withdrawn, difficult to understand the extent of the nationalistic and emotional reaction that the bid triggered. I will come back to this particular transaction in just few minutes, but let me now note the reaction that occurred in Washington was indeed rather shocking; key congressmen and senators appeared on US television and to say that the proposed transaction represented a threat to

US national sovereignty, and that the entire procedure on the United States for reviewing foreign investments for national security considerations needed to be overhauled. There even was even made a proposal whereby the US Congress could override a presidential decision on an Exon-Florio determination, Exon- Florio being the law which these reviews are conducted. Such an override would have deeply politicized the process by which the United States reviews the national security implications of foreign takeovers of US firms and, had such a measure been adopted, it almost surely would have acted as a deterent to foreign investment in the United States. But such investment has unquestionably brought benefits to the US economy, and thus such a measure would have been damaging to US interests. Fortunately, when the passions that CNOOC's proposed acquisition cooled, the Congress backed away from passing legislation to give itself this power to override the President.

Equally disturbing were remarks by French Prime Minister Dominique de Villepin with the respect to a rumored takeover of the French firm Danone by Pepsico. For those of you who don't know Danone, (Koreans might not know it because yoghurt here in Korea seems all to be made by Lotte, the rest of the world knows Danone as the dominant maker of the yoghurt. Boiled to their essence, de Villepin was saying Danone was a French national asset and that under no circumstances should it be allowed to be taken over by a foreign firm because, after all, French national pride and French national security depends upon the domestic ownership of yoghurt production! This struck some of us as being a rather absurd, or even a funny statement. But it was not really funny, because it implied a French nationalistic attitude towards foreign investment that, if acted upon, could deter foreign investment into France. Apparently, in the face of the willingness of the French government to maintain Danone's French nationality, Pepsico backed away from an attempted takeover.

Having condemned United States and France for excessive nationalism with respect to foreign investment, I am not going to let Korea off the hook. We heard this morning that Korea is now open to hostile takeovers. But when Sovereign Asset Management, an equity fund based in Dubai, tried to do a partial takeover of SK Group and where, in particular, all that SAM wanted was change of management of SK Group on grounds that the current management was incompetent and not fit to serve, there was created another national furor where all sorts of condemnatory phrases were used against SAM. Based on my reading of English translations of Korean newspaper articles, the issue triggered as feverish a nationalist response here in Korea as did the Unocal and Danone cases in the United States and France.

All of these examples suggest that there is a plenty of scope for backsliding for national policies with respect to foreign direct investment parrticulary with respect to national treatment of foreign-owned enterprises, e. This suggests also that there are some issue areas that at international level do need some further work, or in some cases even an opening of a new multilateral discussion on these issues. Thus, much as I like Bijit's presentation, there are some issue areas that he failed to cover.

One of the these, indeed that which comes most to mind, is how national security interrelates with foreign direct investment.,What needs clarification is, to what extent should there be a national treatment exception for reasons of national security, and should there be any i limitations on what is an allowable national security exception to national. This issue is going to be hotly debated in the United States in the aftermath of the failed CNOOC bid. One outcome is likely to be proposals to modify the Exon-Florio procedures in United States by which the US President can block a foreign takeover of a US firm., I would suggest that this isn't issue that should be limited to national debate, but rather one that might in fact be placed towards the front of the queue in international discussions.

However, national security is not the only issue with respect to foreign direct investment that might warrant further international discussion. One of the things that didn't quit come out in our discussions thus far is that, with respect to all of the foreign direct investment that has gone on since the 1990s, and which peaked in 2000, then declined somewhat, and now is back on the rise, was that most of this FDI was created by mergers and acquisitions. Indeed, as a mode of entry, that cross-border mergers and acquisitions account for about 80% of the total foreign direct investment during the past ten years. This suggests that there could be plenty of scope for international discussion on a number of aspects of policies toward cross-border mergers and acquisitions, including but not limited to national security considerations. Regulation of mergers and acquisitions in most countries come under the rubric of competition policy. (Indeed, one thing already notedthis morning is that there is a nexus amongst trade, policy competition policy, and investment policies.) Given the high importance of cross- border mergers and acquisitions, this nexus is underscored. Thus, one thing that Bijit might have noted is that not only was investment policy per se taken off the table as a result of Cancun WTO Ministerial, but so was competition and trade policy. In doing so, the Ministers implicitly removed from the table this one potentially very important set of issues, policy with respect to cross-border merger and acquisition. This reflected, I think, some of sentiment among nations that we don't really need to discuss competition policy at an international level, or certainly not in the WTO, an organization that governs trade., But I wonder if that was a correct judgment in light of the importance of cross-border M&As as a means of transacting foreign direct investment.

On this, I might note that what WTO is really about is putting constraints on governments. A central mission of WTO is, in fact, to constrain governments from doing things that may be, or more often are not in their self-interests to do but nonetheless are sought by special- interest groups, and which have potential to cause harm to other countries. What we as economists, those of us who teach classical international economic analysis, might argue is that there can be a global welfare loss from implementation of mercantilistic policy, even if in some cases t such policy can achieve for one nation a national welfare gain. WTO is meant to impeded governments from such implementation. In this matter, I would say that WTO did really well in the creation of the TRIMs agreement, and indeed Bijit tells us that implementation of TRIMs obligations by WTO member countries is now virtually complete. That's extremely good because local content requirements, which TRIMs addresses and limits, do have exactly the potential that I have described, that is, such requirements might perhaps benefit particular countries but, even so, almost surely create global welfare losses.. (That "perhaps" is important, because it is entirely possible that s local content requirements can actually hurt the country that implements them; but even if they do not, they do harm other countries, such that cost of the requirement overall exceeds any benefits that might result from its implementation. Indeed, in a book that I recently edited (along with Theodore Moran and Magnus Blomstrom), there is a very interesting chapter by a Chinese researcher from the State Council Development Research Institute that argues that most local content requirements that have been imposed by China have actually had negative welfare implications for China.[1] In other words, they've been counter productive for China. The good news in that regard is that participation in the WTO TRIMs agreement has given China, and other governments, al reason to get rid of these countereproductive requirements. We of course know that it can be very useful for governments to make policy reforms in response to international obligations because these obligations can be used to override domestic opposition to the reforms, and implementation of TRIMs requirements is a case in point.

The final thing that I want to address, and it will be the end of my brief presentation, is one the issues that Bijit has already addressed, notably investment incentives. Such incentives are subsidies and, like most subsidies, they have the capacity to distort. However, even so, it can be politically very difficult to eliminate subsidies, even where the distortions are very apparent and costly.. I personally have dealt with subsidies for a long time, and, in fact; I spent a couple of years working at the OECD Secretaria. more than 20 years ago where the goal of the work was to examine subsidies and try to find way to do away with the most egregiously bad of these. Alas, I came away with two conclusions from that experience. The first was that almost always, a subsidy is damaging, and ironically, this includes to the entity that creates them. There are very few cases where subsidies do good. Okay, in theory, you can argue that, if a subsidy enables an otherwise unattainable scale economy to be achieved or creates positive externalities, then the subsidy might be desirable. But what I am learned twenty years ago is that, in the real world, such

1) Guoqiang Long (2005), "China's Policies on FDI: Review and Evaluation", in Theodore Moran, Edward M. Graham, and Magnus Blomstrom, *Does Foreign Direct Investment Promote Development?*, Washington, DC: Institute for International Economics.

cases where subsides do create these benefits, are rare. But there are lots of subsidies out there, such that there are far more subsidies than there are positive externalities, or unrealized scale economies. Thus, with few exceptions, subsidies are undesirable. But the second thing that I learned is that, once in place, a subsidy is the devil to get rid of. The recent experience with WTO in agriculture where agriculture threatens to upset the entire Doha Round process illustrates this because what are we talking mostly are various explicit and implicit subsidies to agricultural producers. A whole lot of other countries, including most represented in this room, grant subsidies of one sort or another to agriculture and almost all of them do damage., Thus, they certainly fall into the category of m measures that reduce global welfare, and cause "beggar-thy-neighbor effects as already described by Bijit. For political reasons, however, they are extremely difficult to get rid of, as we learn every day.

Not only in agriculture, but in investment promotion, t there is a lot of subsidization that goes on. I didn't hear much mention of it this morning but believe me it's there. In fact, almost every single major highly publicized foreign direct investment that has occurred in recent times in United States has been subsidized to some extent or another. I don't mean to pick on our host country, Korea, but the latest of these involved a Korean firm, Hyundai Motor Company. Hyundai recently announced the opening of a very largely assembly facility in the US state of Alabama. Indeed, it is claimed to be the the world's largest and most technologically advanced automotive assembly plant, a real marvel. But is was subsidized by the State of Alabama, in which it is located. Was there harm in this instance? I would argue, probably there was, because the location in which the plant was built was not optimal; in the absence of a subsidy, the plant would likely have been located elsewhere in the United States. Thus, wereas from an overall point of view, there might have been a better location for this plant, this particular location was chosen on the basis essentially what government entity would grant the biggest subsidy to the firm, so that private shareholders' benefits would be maximized, but creating a possibility of public welfare losses.

Such losses are not a good thing, and to prevent these is one reason why international rules can be desirable. Thus, to open up this whole area to an international discussion is, I should think, of high importance. However, even though this issue has been proposed a number of times for consideration at the international level, it is proving to be very difficult to get the issue to the negotiating table let alone to achieve any progress in actually reducing subsidies. However, this is an area where I would think that the gains from a future international agreement would be very high.

I am going to close by noting that on this issue of investment incentive/subsidy, until this summer, all of us who have worked in this area might have thought that the target of any future international agreement would have been investment incentives granted by host governments. Thus, for example, in the case of Hyundai, the host government would have been that of the state of Alabama. But, an interesting issue raised by the failed CNOOC bid to take over Unocal was thatit revealed that subsidies can be an issue with respect to home countries as well as host countries. Indeed, one legitimate concern that was raised by this case was that, had it taken place, it would have involved financing at below market rates. Thus, the argument was made that CNOOC would have benefited from a financial subsidy granted by the Chinese government. Now is this good or bad? I won't comment further on this specific case, because I don't really know enough of details to do so. But, looking at the issue in such a case in the abstract.

A reason why a cross- border acquisition might make sense is that by combining two organizations into one organization entity, some sort of efficiency gains might be realized. Indeed, this is one standard economic rational for why any merger or an acquisition might take place. Say that firm A is a candidate for takeover and firms B and C are both bidding for it. Let's say that the efficiency gain that comes from A merging with B is, in fact, greater than from A merging with C. It is then in the world's interest that the merger be between A and B, and, not A and C, and this is so even if a combination of A and C would also create some sort of efficiency gain (because the gain to the combination of A and B would be greater). However, if a financial institution, particularly a state-controlled institution, were to provide lower- than-market financing to firm C for its takeover bid, it is entirely possible that firm C would then outbid the offer made by firm B and thus achieve the merger. Th is would then be once again be a case where the outcome would be globally suboptimal although it might arguably benefit the shareholders of both firms. In fact, the loser in this deal would be the provider of finance; that is to say the government and ultimately the people of the country that provided the subsidized financing for the takeover. Nonetheless, there might be political pressure upon the government to create the subsidized finance.

What this case does suggest is that investment incentive subsidies might go beyond those that we classically have defined, i.e., subsidies given by host countries to attract foreign direct investment. In the case of cross border mergers and acquisitions, as my abstract case illustrates, there can be an issue of subsidization by the home government, where the subsidy would could create undesirable distortions. This raises issues that simply are not touched by the existing multilateral rules but arguable should be.

I think it's time for me to stop talking and let me just say once again to Taeho Bark, it's a real pleasure to be back in Korea and I hope that I'd be able to visit sometimes in the future as well.

# Investment and the Doha Development Agenda

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## Introduction

Although investment issues have been discussed and negotiated at the multilateral level for more than 50 years, they rose to prominence in the early 1980s with a limited mandated agenda on trade related investment measures during the Uruguay Round of negotiations. Progress on this limited mandate was slow. In contrast, the successful conclusion in 1994 of the North American Free Trade Agreement (NAFTA), which incorporated investment provisions and thus revitalized earlier ambitions to achieve a multilateral framework. Subsequently, the Organisation for Economic Co-operation and Development (OECD), attempted to transform itself from a bureaucratic organisation into a negotiating body with the objective of successfully concluding a Multilateral Agreement on Investment (MAI). As is well known, that effort failed in 1998.[1)] At the multilateral level, the First Ministerial of the newly created World Trade Organisation(WTO), held in 1996, initiated a Working Group on Trade and Investment.

Taken together these initiatives established the importance of foreign investment policy as an important component of the multilateral trading system. They also created new challenges for negotiators as the 4th WTO Ministerial with respect to how this policy might be incorporated into WTO rules. The Ministers responded by establishing a mandate in what now is known as the 'Doha Declaration' that, in effect, requires that key substantive decisions be made at the following ($5^{th}$) Ministerial.

Most recent discussion on investment issues in the WTO in fact has been at the very generic stage such that even the most basic question is not fully settled as to whether a formal negotiation will take place. Indeed, if investment issues are not adopted as part of the negotiating agenda at the $5^{th}$ WTO Ministerial to take place in September 2003 in Cancún, some WTO Members would take this as a victory. But, even if this were to happen, many investment policies that might have formed part of an overarching investment agreement will nonetheless be covered in a number of existing WTO agreements. Hence, the question that needs to be answered is, would additional investment rule-making as is proposed in the Doha mandate add new value on economic development

1) A detailed account is provided in Graham, Fighting the wrong enemy (2000).

in poorer countries that is meant to be the focus of the new round, would a new agreement to create investment rules make a tangible and significant contribution to the development process, if such an agreement were eventually included in the WTO? Alternatively, could an equal contribution be achieved via the deepening of existing investment rules or negotiating new such rules within existing WTO agreements? The issue before WTO Members, therefore, is one of the extent to which investment issues in the WTO should be deepened and by what mode, as opposed to the binary question of whether or not the WTO will embark upon negotiation of an overarching investment agreement.

The approach taken in this chapter to responding to these questions is to review the current investment related provisions in the WTO in the next section. The third section examines the mandate for investment issues given by Ministers in Doha while the fourth section as a review of the state of play of the various components of the current mandate. Most of it supports the transition of developing country governments towards a more open and receptive policy framework for foreign direct investment (FDI). It emphasizes the assets possessed by multinational corporations and their ability to contribute to the economic growth and development of a host country[2)]

While the chapter is policy-oriented it is important to note the theoretical and empirical literature on the link between FDI and development. It highlights the fact that while there is very strong evidence supporting the case for investment liberalization there are also possible negative efforts from opening up to FDI[3)]. This is not surprising and in no way would be discounted. Any economic policy will have both positive effects, which require associated adjustment. Some of the specifics of this literature is discussed on a precious paper by Bora and Graham and will not be repeated in this chapter.

## Investment-Related issues BEARING ON Existing WTO AGREEMENTS[4)]

As suggested earlier, critics of the investment agenda at the WTO have tended to focus on the failure of the MAI and to try to use it as an example of why rule making on investment issues would not be in the best interests of countries, especially developing ones. However, this is to ignore the fact that many of the issues related to investment policy-making are already within the multilateral rule making agenda.

One of the most contentious issues at stake, for example, is market access for foreign

2) These assets include additional capital, advanced technology, managerial expertise, and linkage to international markets.
3) E.g. T. Moran, *Foreign Direct Investment and Development* (1998); UNCTAD, World Investment Report 1999: *FDI and the Challenge of Development* (1999).
4) See for a more detailed discussion of the foreign investment related disciplines in the WTO; WTO, *Annual Report : Special Topic Foreign Direct Investment and Trade* (1996); M. Koulen, 'Foreign Investment in the WTO' in E.C. Nieuwenhuys and M.M.T.A. Brus (eds), *Multilateral regulation of Investment* (2001) 181-203.

investors. This involves national and most favoured nation treatment for foreign investors, which were among the cornerstone principles of the MAI. The issue is taken up in some details in the next section, since it is partly covered in two existing WTO agreements; the Agreement on Government Procurement (AGP) and the General Agreement on Trade in Services (GATS). The standard provided in these agreements, and indeed, other agreements such as Bilateral Investment Treaties and the NAFTA is national treatment for foreign investors. This means providing treatment to foreign investors which is no less favourable than that provided to domestic investors. A corresponding principle is the most-favoured-nation (MFN) principle, which prohibits discrimination between investors from different countries.

The AGP provides that there be no discrimination against foreign suppliers and, also no discrimination against locally established suppliers on the basis of their degree of foreign affiliation or ownership.[5] The GATS treats foreign investment in the service sector as a mode of supply.[6] This is done by defining the commercial presence of a foreign supply as:

[A]ny type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supply a service".[7]

Another mode of supply is through the presence of 'natural persons'. Koulen (2001) argues that this is closely related to the commercial presence mode since it includes the temporary entry of business visitors and intra-company transfers of managerial and other key personnel[8].

One word of caution or clarification: while the GATS and the AGP have elements of market access for foreign investors, their architecture differs substantially from that proposed in the MAI or from Chapter 11 of NAFTA. One of the key differences, with respect to the GATS is that there is no general obligation. Members apply the standards of treatment through specific commitments. These commitments apply only to the listed sectors and reservations and exceptions expressed by Members.

One final note with respect to market access is the role of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). While the agreement itself does not provide a standard of market access it does provide for a standard of intellectual property rights protection. One element of the determinants of FDI flows is the extent to which a firm specific asset can be protected from either expropriation of dissipation[9]. If

5) The agreement also has a provision against the use of offsets, which for the most part is parallel to the issue of performance requirements.
6) Investment aspects also has a provision against the use of offsets, which for the most part in parallel to the issue of performance requirements.
7) GATS Art. XXVIII.
8) Koulen, *supra* n. 6.

intellectual property rights protection are of a sufficient standard it could induce FDI flows.

A second area where disciplines already exist is with respect to investment measures that can be linked to trade. In this respect there are measures, which, on the one hand, condition the behaviour of affiliates of foreign enterprises, and on the other, used to attract foreign investment.

With respect to this second area, coverage is at least potentially already established in the Agreement on Subsidies and Countervailing Measures (ASCM) for industrial products, the Agreement on Agriculture for agricultural products, and the GATS for services. The establishment of a first of these agreements, which provides remedies to challenge the use of subsidies, was a major achievement of the Tokyo Round of Multilateral Trade negotiations; the agreement was further modified during the Uruguay Round. However, the extent to which this Agreement and the two others actually cover investment incentives is not very clear. The first and foremost reason for this ambiguity is that these agreements explicitly cover trade in goods and services and not foreign investment. Therefore, if there is a link, it must be through the relationship between investments and trade in goods and services.

The ASCM in particular raises ambiguities. The ASCM is a very broad agreement and contains a number of specific steps that are used to determine whether or not a measure comes under its jurisdiction. For example, a three-part definition is used to determine whether the measure is indeed a subsidy. These are a clear financial contribution that must be provided by a government or any public body within the territory of a Member that confers a benefit. A second condition is that the measure must then be specific to an enterprise, or group of enterprises.

Most measures that can be classified as investment incentives would indeed seem to fall within the jurisdiction of the ASCM on the basis of these criteria, or at least so with respect to industrial goods as covered by this Agreement. However, a number of additional factors must come into play before a subsidy is ruled as inconsistent with the ASCM and subject to discipline. To begin, it must be established whether the subsidy falls into a category of prohibited subsidies. This category includes specific trade-related subsidies, such as direct export subsidies and subsidies that are contingent on exporting. The burden of proof rests with the complaining party. If this is established, the complaining member must show that it has suffered adverse effects. This means that either its domestic industry producing like industrial goods has suffered injury from imports sourced from the country offering the incentive, serious prejudice arising from export displacement in either the market of the country offering the incentive or a third market. Finally, Account mest be taken of nullification and impairment of benefits from improved market access that is

9) K. Maskus, 'FDI and Intellectual Property' in B. Bora (ed.), *Foreign Direct Investemnt: Research Issues (2002).*

undercut by subsidisation. Importantly, whether or not investment incentives can be shown to have these prejudicial effects has not been established; a main reason is simply that no cases have been brought to the dispute resolution process by which some sort of concrete precedent could be set.

The Agreement on Agriculture provides special provision for agricultural products. These provisions for the most part insulate subsidies to industries that produce agricultural products from the disciplines contained in the ASCM. However, after 1 January 2003 the ASCM agreement is meant to apply to subsidies for agricultural products.[10] But, again, no cases have come up whereby investment incentives to foreign investment in agriculture have been challenged under ASCM.

Therefore, for those types of measures that might be classified as investment incentives, the WTO Agreements provide potentially broad although as yet untested disciplines. The policy question is whether specific application of these agreements should be allowed to be determined by future dispute cases or, alternatively, should be interpreted with respect to investment incentives?

As already noted, selective government intervention meant to affect performance of foreign investment is already partially covered under the Agreement on Trade Related Investment Measures (TRIMS). Actually, the fact that this text is called to be a full—blown WTO Agreements is something of a mystery. This is because the TRIMS agreement at present does little more than clarify the application of GATT 94 articles III (4) on national treatment and XI (1) on quantitative restrictions.[11] It does not even define a trade related investment measure. Instead the approach taken was to include an illustrative list of measures, which were agreed to be inconsistent with the two key paragraphs of the GATT (III.4 and XI.1).[12] This list covers measures that are mandatory or enforceable under domestic law and administrative rulings and measures for which compliance is necessary to obtain an advantage. The list includes local content schemes, foreign exchange and trade balancing, and export-restrictions. There is no text specifically addressing issues related to granting national treatment to investors.

The TRIMS agreement allowed any WTO Member access to an extended transition period for bringing policies that they might have into compliance with it, if and only if the

10) Subject to the provisions of the agreement as set forth in Art. 21.

11) The TRIMS Agreement is a rather modest attempt at disciplining policies that are targeted at foreign enterprises and which came about through conflicting positions on the extent to which investment issues should be covered by the WTO. Many developing countries resisted the extent to which market access for foreign firms would be covered, and as a result the negotiations focused on policies that applied to the operations of foreign firms. Even then, negotiations proved difficult, as there was no consensus as to whether or not a specific policy instrument was indeed trade distorting. Furthermore, some developing countries took the position that they should have access to policy instruments that could be used to offset any perceived negative effects associated with the operations of trans-national corporations.

12) There was nothing to suggest that the list was exhaustive of all the measures that could be considered to be inconsistent.

relevant measures were notified within 90 days of the commencement of the Agreement. Twenty-six members, all developing countries but of widely varying economic characteristics notified a variety of measures[13], most of which were local content schemes. The second most frequently notified measure was foreign exchange balancing. Subsequent to the expiry of the transition period, 11 Members applied and were granted extensions until 2004.

The basic issue regarding TRIMS Agreement is whether it should be extended beyond clarification of measures that might be inconsistent with GATT Articles III and XI.[14] Indeed, during the Uruguay Round negotiation of the Agreement, a number of types of 'performance requirements' placed on foreign investors by governments that might create trade distortions but were not necessarily inconsistent with the two GATT articles were identified and proposed for inclusion in the Agreement[15]. But, as a compromise among the negotiating parties, all of these were removed from the Agreement more or less at the last moment. (Hence, the answer to the "mystery" noted above: had it not been for this last-minute compromise, the TRIMS Agreement might have indeed evolved into a full-blown agreement and not a "clarification" of existing GATT obligations.)

In addition to market access for investors and potential disciplines on incentives and performance requirements there are also provisions in the Agreement on TRIPS Agreement that have the potential to protect an investor's assets[16]. Some developing countries have argued that these provisions are "overreaching" and in fact impede development. Whether or not these claims have merit is hotly disputed. However, at the present time, it does not appear that any existing provisions of the TRIPS Agreement will be subject to renegotiation during the Doha Round.

## Is there any value added by including a new investment agreement in the doha development agenda?

The investment-related paragraphs of the Doha Ministerial mandate recognize a case for a multilateral investment framework to secure transparent, stable, and predictable conditions for long-term, cross-border investment, particularly FDI that contributed to the expansion of trade:

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13) B.Bora, *Foreign Direct Investment: Research Issues* (2002).

14) An interesting aspect of the Panel decision on India is that it found the measures to be inconsistent with III:4 and XI:1 and chose not address the claims under the TRIMS agreement. While it is tempting to interpret this as an irrelevancy of the TRIMS agreement the decision was based on judicial economy, as opposed to a judicial interpretation of hierarchy of agreements. See WT/DS146/R, 21 December 2001.

15) See E. M. Graham, and P.R. Krugman, 'Trade Related Investment Measures' in J.J. Schott (ed.), *Completing the Uruguay Round: A Results-Oriented Approach to the GATT Trade Negotiations (1990).*

16) See Maskus, *supra* n. 11.

*Investment work program in the Doha Ministerial Mandate*

20. Recognizing the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade, and the need for enhanced technical assistance and capacity-building in this area as referred to in paragraph 21, we agree that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations.

21. We recognize the needs of developing and least-developed countries for enhanced support for technical assistance and capacity building in this area, including policy analysis and development so that they may better evaluate the implications of closer multilateral cooperation for their development policies and objectives, and human and institutional development. To this end, we shall work in cooperation with other relevant intergovernmental organisations, including UNCTAD, and through appropriate regional and bilateral channels, to provide strengthened and adequately resourced assistance to respond to these needs.

22. In the period until the Fifth Session, further work in the Working Group on the Relationship Between Trade and Investment will focus on the clarification of: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between Members. Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest. The special development, trade and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable Members to undertake obligations and commitments commensurate with their individual needs and circumstances. Due regard should be paid to other relevant WTO provisions. Account should be taken, as appropriate, of existing bilateral and regional arrangements on investment.

The identified issues concern both the liberalization of foreign investment and its operation once established in foreign markets. It recognises the points made in the previous section that foreign investment in general, and FDI in particular, is seen as a way of transferring needed capital as well as other assets, such as technology, managerial skills, and improved access to export markets to host countries.

Nevertheless, potential drawbacks of foreign investment should also be noted. Of particular concern is the impact of short-term and volatile capital flows on the macro-economic and balance- of-payments stability of host countries. Other concerns include the impact of foreign investment on domestic investors, competition in host-country markets, domestic savings and consumption patterns, and the ownership of productive and financial assets. The Doha Ministerial mandate thus places particular emphasis that any multilateral framework must reflect the special development, trade and financial needs of developing and least-developed countries, and on allowing Members to undertake obligations and commitments commensurate with their individual needs and circumstances. This includes that any prospective investment framework in the WTO must preserve the right of Members to govern and regulate in the public interest. It is emphasized also that creating a more open and stable climate for foreign investment is itself an important development objective. Not only do developing countries have an interest in encouraging inward investment and the benefits that accrue from it; these countries also have a growing interest in creating a more secure international framework for outward investment, as they increasingly became exporters of FDI and home countries to trans-national corporations.

The negotiators thus provided a mandate that could best be described as pragmatic. The pragmatism arises from the recognition that existing WTO rules already partly cover the four substantive key issues. For example, market access via FDI in the context of services (but, importantly, not industrial goods) is covered under commercial presence under the GATS. Disciplines on government subsidies towards investment as they relate to merchandise trade are not identified in the Doha Declaration because, as noted in the previous section, they potentially are covered under the ASCM and the TRIMS Agreement. These agreements might not be as fully developed as they could or even should be, but negotiations to enlarge or clarify their coverage could be argued better to fall under negotiations specific to these agreements, not to a new agreement. (On this, however, see our concluding remarks.)Even so, the Ministers of the WTO Member states did agree to include the relevant paragraph in the Declaration. Given the lack of consensus on the intrinsic value of investment-related rules, a plausible question is in fact why Ministers agree to the mandate at all. Four reasons can be put forth.

### A. Coherence argument

Coherence in the WTO context usually means the aligning of the policies and practices of WTO with those of the World Bank and the International Monetary Fund (IMF). However in this context, we mean coherence between trade and investment policy. The intellectual history of FDI started with a supposition that trade and FDI are substitutes. In this context, FDI was seen mostly a means to overcome a tariff barrier. Over time, however, this dichotomy has blurred substantially. Both evidence and theory provide reasons for trade and FDI to be complements[17]. The blurring is amplified by the fragmentation of production, which causes intermediate products to be cross-hauled among various subsidiaries of transnational corporations. A good example of that trade and investment are in fact complementary is the identification of *investment* restrictions as a non-tariff *trade* barriers (NTTBs) by the private sector. A recent survey found that investment measures are one of the most frequently cited NTTBs by the private sector[18]. Hence, the reduction of tariffs over the past 50 years has, in some sense, increased the need to address foreign investment barriers as one type of trade barrier at the multilateral level.

### B. Single undertaking

The Uruguay Round agreements expanded the scope and mandate of the WTO in an unprecedented fashion. In addition to extending the rules-based discipline to agriculture, textiles and clothing, new agreements covering intellectual property, trade in services, and contingency measures were concluded. That these agreements all became part of a single undertaking happened because, given the diversity of trading interests of the WTO Membership, some of the underlying issues are relatively more important to certain Members than others, and interests of the membership are not symmetric. Thus, concessions could be granted by one Member in exchange for concessions by other Members, enabling progress on a range of issues where such progress might not have been possible had each issue been separately negotiated. Much the same can be said for investment. Progress on investment might in fact result from progress on other issues. For example, one of the more accepted political realities of the Doha Round of negotiations is the pressure on the European Union (EU) to reform its agricultural policy. This could be done unilaterally by the EU, of course. However, this is unlikely in today's mercantilist world, and thus there it is a political need for the EU to receive a 'concession' in return, even if it is most likely the EU itself that would receive the most benefit from reform of its agricultural policy. Such a 'concession' might come in the form of movement on the investment front; the EU has been the leading advocate of expansion of WTO rules to cover investment. In the words of Hoekman and Saggi, progress on investment in the WTO could be part of a 'grand bargain[19]'.

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17) See J. Markusen, ' Foreign Direct Investment and Trade' in B.Bora (ed.), *Foreign Direct Investment: Research Issues (2002)*; E. M. Graham and E. Wada, *'Is Foreign Direct Investment a Complement to Trade' in E. M. Graham Fighting the Wrong Enemy* (2000). Appendix B.

18) OECD, *Overview of Non-Tariff Barriers: Findings from Business Surveys* (2002).

19) B. Hoekman and K. Saggi, 'Multilateral Disciplines and National Investment Policies' in B. Hoekman, A. Mattoo, and P. English (eds), *Development, Trade and the WTO: A Handbook* (2002).

### C. Changing business environment

An important element of international trade policy is that it should be relevant to the private sector. As such, it must be noted that international business today is conducted quite differently than it was as recently as 15 years ago. In particular, falling barriers to the international trade in goods and services, combined with rapidly changing technology, have caused significant changes in the organisational structure of businesses. Lower tariff and transport costs, plus improvements in information technology, have made it increasingly easier to locate different stages of production in different countries, to take advantage of special characteristics of each country. As this happens, intra-firm international trade in "intermediate goods" (e.g., components, subassemblies, and semi- finished goods) rises. In order to take advantage of these investments goes beyond the traditional view that FDI is simply 'greenfield' type investments of 100 percent ownership. In many cases, the investments are joint ventures or licensing and contracting relationships. An increasing need thus arises that the rules on international trade take into account the various forms in which international investment takes place.

### D. The complicated architecture of plurilateral rules

While investment rule making at the multilateral level has proceeded slowly, this does not mean it has not proceeded at all. Many countries have been quite active in this area over the past 15 years. The initiatives range from the comprehensive and controversial Chapter 11 of the NAFTA to the many bilateral investment treaties (BITs) currently in force. These instruments differ greatly in terms of their coverage and level of discipline.

This increase in activity raises the issue of consistency and discrimination. BITs are not necessarily the same between countries and investment provisions in regional trade agreements (RTAs) such as NAFTA chapter 11 vary considerably. Moreover, differences among various instruments can lead to inefficiencies and distortions. As a result, the proliferation of such agreements raises the issue of whether or not a multilateral approach would be superior for reasons of efficiency to a network of BITs and investment agreements within RTAs. A single multilateral instrument would also arguably create a more equitable environment for investment than would a patchwork of inconsistent agreements.

## State of play in investment negotiations[20)]

Paragraph 22 of the Doha Ministerial Declaration mandated the Working Group on the Relationship between Trade and Investment to focus on *clarifying* the following issues: scope and definition; transparency; non-discrimination modalities for pre-establishment

20) Much of this section is based on the discussions of the Working Group on Trade and Investment in 2002. See the Annual Report of that Group for further details, WT/WTGTI/6.

commitments based on a GATS-type, positive list approach; development provisions exceptions and balance of payments; consultations and the settlement of disputes between members. In addition, the Working Group also continued work on the relationship with other WTO agreements and International Investment Agreements and also on the issue of FDI and the transfer of technology. Each of the seven issues identified in paragraph 22 are now considered in turn.

### A. Scope and Definition

There are two main approaches to defining investment - an intrinsically narrow approach, such as an enterprise-based or transaction-based definition, on the one hand, and a broad, asset-based approach, with different options for including or excluding various categories of investment. The US for the most part has championed the broader approach. A number of developing countries, on the other hand, proposed a narrower approach, e.g., that any coverage of any future WTO agreement be limited to FDI (but see subsection on balance of payments below).

In addition to the difficulty of defining investment, there is the added difficulty of defining what exactly is an "investor" for purposes of implementing an investment agreement. This is an important issue because implicitly any agreement involves rights and obligations of investors, as opposed to governments. For example, if a future agreement were to guarantee national treatment to investors and/or their investments, it would be of paramount importance to define precisely what entities qualified for this treatment.

### B. Transparency

In describing the objectives of a multilateral investment framework, Ministers at Doha began with the concept of securing a 'transparent' framework for foreign investment. The discussion in the Working Group did not focus on the benefits of transparency, but rather on the nature and depth of transparency provisions and on the scope of their application in a possible WTO agreement on investment.

Some possible transparency obligations discussed in the Working Group are:

- Publication and notification requirements
- Enquiry points
- Prior notification and comment
- Administrative and judicial procedures
- Investor and home-country obligations

At this point in time, the positions of individual WTO members on what transparency-related obligations should be contained in any future investment agreement are not fully clear.

### C. Development Provisions

The main areas where developing countries are seeking flexibility in any WTO agreement on investment are in regulating the entry of foreign investment (through general screening, selective restrictions, and conditions on entry) and in using policies to enhance the contribution that foreign investment can make to their economic and social development needs and objectives (through performance requirements, investment incentives and preferences for domestic investors). Not surprisingly, a consensus on exactly what approach is best from a development perspective does not exist. Rather, views range from it being desirable that there be widespread scope for government intervention or, alternatively, that there be strong obligations on governments not to use such intervention on a selective basis. Various broad options have been identified during the period after the Doha Ministerial during discussions in the working group. These are:

- That the development objectives of an agreement on investment be included in the preamble of the agreement.
- That the scope of an agreement be clearly delineated — e.g., that it be made explicit whether the agreement applied to FDI only or to all forms of investment, and whether it covered the pre- as well as the post-establishment phase of investment;
- That the agreement should allow at least some exemptions from obligations;
- That Member countries be allowed some flexibility in undertaking specific commitments;
- That any agreement allow longer transition periods for implementation for poor countries than for richer countries; and
- That some means should be provided for technical assistance and capacity building for poorer countries.

Furthermore, it should be recognised that the seven issues listed for "clarification" in paragraph 22 did not exhaust the scope for development provisions; rather, one could expect further discussion to reveal whether certain items should be excluded from the list, and whether new items should be added.

### D. Non-discrimination

The principle of non-discrimination is at the core of most international commercial treaties, although its application is typically subject to carefully defined conditions. These conditions might allow governments to give preferential treatment to domestic products, producers and investors, or to certain of their commercial partners but not to others, or to pursue domestic policy objectives that could not be realized without practising some degree of discriminatory treatment. The scope for the application of non-discrimination can also be limited by the definition of "investment" in an agreement — i.e., by the range of assets to which non-discriminatory standards applied.

An important distinction can be drawn between the application of non-discrimination - and national treatment in particular - at the pre-establishment and post-establishment phases of investment. Similarly, MFN and national treatment also differ. An argument can also equally be applied to the application of the national treatment standards. National treatment, like MFN treatment, could also be extended to all stages of investment - its entry, its operation after establishment, and its liquidation. In doing so, however it will be important to take into account the need (or at least preference) on the part of some developing countries to have some flexibility to discriminate between domestic and foreign investors.

In the context of the discussion of non-discriminatory standards at both the pre- and post-establishment phase, it is important to note, once again, that scope of application depends crucially on the definition of the term 'investment', as well as on the exceptions allowed and the specific commitments made under the agreement's provisions by individual Members.

### E. Modalities for Pre-Establishment Commitments Based on a GATS-Type Positive List Approach

The GATS approach to scheduling market-access commitments has been suggested in paragraph 22 as a model of development-friendly multilateral rules. Discipline is achieved through the binding of policy, but at a pace that is consistent with the needs of each Member. At the same time, there are also valid criticisms about the degree of the liberalisation that could be realised through such an approach. Bindings have policy value in the sense that they are credible commitments of policy, but under the GATS approach, different countries can put forth significantly different bindings. Moreover, it has been argued that, under the GATS approach, the degree of effective liberalisation has been limited to the status quo; countries have been to date unwilling to bind themselves to any commitment that does not already exist under current law and policy.[21]

### F. Exceptions and balance-of-payments safeguards

Another element for consideration is ways in which general, security, and regional

21) Indeed, a frequently heard complaint about GATS is that national commitments under GATS often are less than the *de facto* status quo. In other words, the extent of *de facto* liberalization actually exceeds that achieved *de jure* under GATS. Defenders of the GATS approach counter that, while this latter might be true, GATS is an unfinished work that will, with time, achieve a net liberalization. Whether this proves true, of course, only time will tell.

integration exceptions as well as balance-of- payments safeguards might be incorporated in a prospective WTO investment agreement. An issue of great importance to some developing countries is balance-of-payments safeguards, since it touches directly on concerns about short-term capital flows and exposure to financial volatility. Indeed, such concerns are at the heart of why these countries seek that any such agreement be limited to cover foreign direct investment only. However, it is also noted that foreign direct investors do engage in short-term financial transactions, and thus it is argued that even an investment agreement that is limited to foreign direct investment must contain some balance-of-payments safeguard, perhaps one similar to that already contained in the GATT (which in turn is meant to be consistent with International Monetary Fund (IMF) rules regarding balance of payments).

### G. Consultation and the settlement of disputes between Members

Although there are different models for settling investment related disputes (e.g., NAFTA chapter 11, which allows for private parties in some circumstances to initiate dispute settlement procedures under so-called investor-to-state provisions), judging from reports of the Working Group that there is a widely shared view that the existing WTO dispute settlement mechanism should apply to any future investment agreement - just as it applied to all other WTO agreements. Moreover, there seems to be a widely shared view that the WTO would not include investor-to-state dispute settlement procedures such as are found in the NAFTA. Even so, there is no doubt that the application of the existing WTO dispute settlement system to investment obligations and disciplines would raise a number of issues that would require further examination and clarification such as: the scope for non-violation actions; extending cross-retaliation and cross-compensation to the investment area; the interaction of investment rules with other substantive rules in existing WTO agreements; and the relationship with other dispute settlement systems in existing international investment agreements.

## Conclusions

Much of the concern about a possible framework agreement in the WTO for FDI is the possibility that it may shift the balance of rights and obligations of foreign-controlled firms operating in a national jurisdiction. Some such concern is warranted and we would not quarrel with that, although elimination from consideration at WTO of NAFTA-like investor to state dispute settlement procedures takes some of the edge off of this concern. The focus of this paper, however, is on the issue of whether or not good investment policy requires a multilateral system of binding and enforceable rights and obligations. The chapter takes as a starting-point the ongoing debate on the link between FDI and development but, at the same time, is not strictly necessary for development to occur.

In our view, the ground has now been prepared sufficiently to move the agenda on investment forward. Each of the proposed issues has been covered and there has yet to be a claim that technical assistance delivery has not been fulfilled. The difficulty at this stage is whether or not the differences among WTO Members that have emerged can be resolved outside a negotiation forum. For the most part, discussions on investment within the WTO so far have avoided any use if the term 'negotiation'. But, even to the casual observer, the nature of the national position papers and the report of the Working Group on Trade and Investment suggest that the Members have not been merely engaging in discussions aimed at achieving some sort of intellectual clarity but rather, they have been *de facto* preparing for an upcoming negotiation.

In this respect two matters can be identified that bear on whether a constructive negotiation is now likely to ensue. First, there does exist a group of Members who remain steadfastly opposed to investment issues in the WTO under any circumstances. Exactly which Members are in this camp is, however, not wholly clear, as many countries have maintained a stance of deliberate ambiguity in this issue. The 'anti-investment' camp might be limited to India and certain of the Association of Southeast Asian Nations (ASEAN) countries. But, it could include a majority of developing countries. Since the exact numbers are not known the probability that the 'Indian position' (i.e., do nothing on the investment front) is likely to carry the day remains uncertain.

The second matter compounds the first: there is genuine concern on the part of a number of developing countries that, even if they were in the end to support investment negotiations, they do not have the power or capacity to negotiate an agreement that is in their interests. Thus, these countries might be classed as ones that believe that although an agreement that indeed is in their interests is feasible, nonetheless the actual outcome of a negotiation could very well be an agreement that is antithetical to their interests.

The existence of these two groups of developing nations must be taken into account when viewing the broader context of the negotiations. How these groups play their cards in Cancún will bear greatly on the nature and extent of any negotiation on investment. The most divisive but key issue in the upcoming round of negotiations, for example, is not investment, but agriculture. *Demandeurs* for agricultural reform could very well be willing to use investment negotiations as a 'bargaining chip' to affect the outcome in agriculture, regardless of whether or not they fundamentally support inclusion of an investment agreement in the negotiations. Thus, developing countries in the second of the two groups, and perhaps even in the first, might be quite willing for extensive negotiations on investment to proceed, if this would induce the EU to reduce its resistance to reform of its agricultural policy. Investment could prove to be a bargaining chip with respect to other issues as well, e.g. access to essential medicines. In the end, whether there is to be negotiated an investment agreement in the WTO might thus itself be a matter to be negotiated.

We conclude by noting that if negotiations to conclude an investment agreement do proceed in the WTO, there is a major issue lurking that must be resolved that we have already hinted at. This is whether the new agreement would supplant existing rules bearing on investment in the WTO. For example, provisions pertaining to market access (national treatment, MFN) are already part of the GATS, as already noted. Would parallel provisions in a new investment agreement supersede? Some parties have already suggested that the answer should be 'no' and thus that a new investment agreement might cover only goods and not services, much as the present GATT covers trade in the former while GATS covers trade in the latter. However, some private parties have objected to this, noting in particular that many foreign-invested operations in practice deal in both goods and services and thus that it would be undesirable to have two agreements in effect that could be inconsistent with one another. It also has been pointed out that the reason why GATS covers investment in services is because, when the GATS was first negotiated, there really was no prospect for WTO rules on investment; because trade and services and investment in services are highly interwined, the GATS negotiators realized that the new services agreement would have to cover at least some investment-related issued. In this context, the GATS agreement could be seen as provisional with respect to investment coverage. i.e. filling a lacuna that then existed. Once the lacuna is removed, arguably, the need for investment-related provisions in the GATS would expire, and the new agreement could thus be written to supersede GATS. Similar statements could be made about other investment-related issues, e.g. the unresolved issues in the ASCM could be resolved by explicit provisions pertaining to investment incentives on an agreement, could be incorporated into an agreement on investment.

On the issues of the previous paragraph, however, we don't pretend to have the final word. Rather, we simply note that these issues of consistency and possible overlapping coverage between an agreement on investment, if one is negotiated, and existing provisions of existing WTO agreements pertaining to investment, must be dealt with.

## EPILOGUE

This chapter was drafted prior to the 5th WTO Ministerial Conference, which was held in Cancún in September 2003. The outcome of that Ministerial is well known to all who follow trade policy issues; there was no agreement on the 'Singapore issues', of which investment was one, and in the end investment was dropped altogether from the negotiating agenda. Media reports indicate that the Chair of the Conference, Minister Derbez of Mexico, gavelled the meeting to a close when a group of key ministers were unable to agree on the number of Singapore issues that should be included in the Doha negotiations. One group of countries argued that all four should be included, whereas other countries argued none should be included. The precise number for and against is not known.

Pascal Lamy, the Trade Commissioner of the EU, in order to obtain an agreement, offered to 'drop' competition policy and investment from the negotiating agenda. This offer set the stage for what appeared to be a battle of numbers; a bidding war, so to speak. Instead of negotiating all four issues, Commissioner Lamy was offering to negotiate only two. To this day, his reason for deciding on which two to negotiate are not well known, but could be found in the fact that some negotiating countries considered negotiations on transparency in government procurement and trade facilitation less contentious.

The mood, atmosphere, and level of debate about what had occurred in Cancún was strange; some suggested that the trading system was headed for a complete collapse, others suggested that the failure was an example of the trading system, working at its best. Whatever one's perspective, it was clear that the EU, the principal champion for expanding rules on investment policies in the WTO, had lost interest in this issue. Without such a key player, other WTO Members who championed the issue continued, but with a substantially diminished negotiating position.

In Cancún,, Ministers agreed to a deadline of 15 December to move the negotiations ahead, or to do what couldn't be done during the Ministerial Conference. That deadline was not met and in recognition of the fact that two key individuals in the push for a new round of negotiations, the US Trade Representitive Robert Zoellick and Pascal Lamy were likely to be in different posts by the end of 2004, WTO Members made a concerted effort at coming to an agreement on the directions of the negotiations would commence on only Trade Facilitation. The remaining three issues would be 'dropped from the negotiating agenda'.

The purpose of this epilogue is not to lament the fact that investment has been dropped from the Doha negotiations. As indicated in section III, the final decision on whether or not to undertake negotiations would depend on the contours of a 'grand bargain'. This would not be the first time that tactics and strategies come to the forefront. Indeed, as pointed out before, the EU views investment as one of its 'offensive' positions. In losing investment, it will now focus on other areas of the negotiations.

The fact that an agreement was reached in July 2004 to revive the broader negotiations is a good thing. Perhaps the most important issue is the sense of *déjà vu* with regard to investment and the multilateral trading system, a parallel even to what we witnessed in Cancún more that 55years ago in the Havana Charter. Will it be another 55 years before investment again is raised in the WTO? Who knows? Predicting whether and when investment comes back on the WTO negotiating table is the subject for another book. For now, this chapter can close by highlighting the paradox that, despite investment being dropped from the WTO's formal agenda, it continues to be one of the key negotiating issues in RTAs, which complements the growing number of BIT being signed by developing countries. Moreover, as noted in this chapter, investment continues to be a key component of a number of ongoing issues within the WTO; the decision to drop negotiations on investment rules *per se* does not change the fact that investment remains on other agendas within the WTO. Taken together, investment rule-making and policy disciplines are still a fundamental aspect of good development policy.

# Session 3: Corporate Governance for Investment

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**Presentations**

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Mr. Mats Isaksson, Head, Corporate Affairs Division, OECD
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# Corporate Governance for Investment

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Thank you Mats for a long introduction. I'm from Korea University not from Seoul National University. Korea is larger than Seoul at least. Good afternoon ladies and gentlemen. It's my great honor to be here particularly speaking to the honorable audience who has a common interest in developing Asia pacific region. Let me not talk about why corporate governance is important in using investment from the broad and local the like. Because there has been tons of papers, which have been shown, the better the corporate governance the lower the cost of capital. Certainly that creates the higher value fro the company with the same profit and the cash flows. In the past particularly in the 80s and the early 90s, these research on corporate governance was focused on develop the market only such as the US and the UK. And then many scholars were asking why they didn't find a strong link between better corporate governance and better corporate performance. That was particularly due to the efficiency of the capital market and the company is not doing well either in corporate governance or in their performance the company exited from the market immediately. Such as we have witnessed, Enron, Enron was one of the largest company in US and when they revealed all those irregularity in accountings and business practices, the market penalized them immediately by kicking them out of the market, which is not the case in less developed and emerging market country, certainly including Korea. Even some company known to have problem in corporate governance and problem in not generating profit for a number of years, still the company remains in the market. And that certainly weakens the competitiveness not just that particular company but also other companies in the same country.

So let me not get into such a discussion in why we need this corporate governance in place. Rather I will show you where the Asia stands in the quality in the corporate governance using various surveys done by other multinational institutions. Let me start with somewhat old survey done by the Price Waterhouse Coopers, which is the largest accounting and consultant firm in the world. They surveyed 35 countries, which include 30 emerging market companies, and 5 less developed market measuring the opacity of the market practices. The ones that are in yellow are the country in East Asia. There are certainly Pakistan, India and other Asian countries but I highlighted the ones in East Asia. As you can see except Singapore and Hong Kong, other Asian countries, particularly East

Asian countries aren't doing well in terms of this Opacity, which means the business is not done in transparent matter. Unfortunately Indonesia and China came the last, and Korea was not far from there. That was like four years old survey, more recent one was one done by the world economic forum, which are often referred as Davos Forum by the press, this is probably one of the most friendly organization to the business in the world; Kind of the global business summit. And they're also quite concerned about the quality of the corporate governance. So they formed a corporate governance committee and then did some survey on the quality of corporate governance across 49 countries. Here again I have listed the Asian countries, how the Asian countries appear in the survey and again I'm sorry for the friends from this region, China, Indonesia, and Philippines were not doing well, and the India, Korea, Pakistan and Japan are somewhere in the middle, again, Singapore and Hong Kong did quite well; Almost to the level of the developed market. Another survey which every year the Credilion is producing in Asia, they survey on corporate governance on 10 East Asian and South Asian countries, then they publish every year. Here again you can see that Singapore and Hong Kong did quite well, and Malaysia, Korea, Taiwan, Thailand are in the middle, and again those three countries are at the bottom. Another survey, not really on corporate governance but the institute of management and development based in Switzerland, they produce country competitiveness every year and then within that report there are factors that look at the quality of corporate governance across the countries. Here Korea did not do well, and again Singapore and Hong Kong did quite well, and among those countries, Malaysia and Taiwan did reasonably well. What it shows is, the Asian countries are not doing well in terms of corporate governance. This means the business is not done in transparent matter and not done in a countable manner.

Then we should ask ourselves, why we observe such a poor corporate governance practice in Asia. I think the first reason I can think of is establishment rent seeking behavior is preventing the good corporate governance practices. In particular the root cause of this poor corporate governance is coming from the concentrated ownerships. Family ownership is okay but the family does not just own, they're also running the company generation after generation. So the capital market is not functioning well because the ownership is not so well diverse across different shareholders. And also even there has been great deal of improvement in the rules and regulations in governing the corporate governance after the 1997 crisis, still the shareholders are not well protected and many of the shareholders are very inactive. I mean, we don't expect the individual to rise up and raise issues against the giant corporations but certainly we do expect the institutional investors who has a fiduciary duty to protect small minor investors but in Asian region, I don't see any one single institutions that practices really good investor protection in terms of their roles in the capital market. And even though we have introduced rules and regulations to improve the corporate governance still the common phenomena across the region is rules are not enforced as it is intended. Certainly the accounting fraud is not just in Asia, we have seen what's been happening in Enron and other part of the world but still in Asia, we do have quite a lot of scandals involving this accounting fraud and in many cases even though we have the law, knowing the law is not enough, those guys who know the judge has a better influence and outcomes of the dispute on the corporate governance issues. This graph shows how complicated the ownership structures are. This, you may not be able to read the Korean character, but what it says is as you can see is the Samsung group's, the ownership structure among 63 companied under the umbrella of Samsung. There is no way that any of you can easily figure out who owns who. It's not unique to the Korean company it is quite common across most of the large family owned and managed company in the region.

So there's got to be some way we resolve this issue. Which one of our Korean large chaebol has done this is the ownership structure of the LG group which had a similar complicated ownership a few years ago, but they created the holding company and made this much simpler, and now probably if you have monitored the Korean market, you would have fined that the Korean LG share price has gone up steadily over last 2 years, about to 3 times of what it used to be. I did a very simple regression. I'm not claiming the causality which way it runs but at least there are a number of studies that shows that the degree of the financial market development which I mean by that is the size of the banking and the stock market to the growth domestic product and there's a clear if not the causality there is a clear link, correlation between the degree of the financial market development and the country competitiveness. And surprisingly, if there is well-established financing market which means we have a better corporate governance then there is a less corruption in the entire society. And also let me point out at the 9 what we call as the future growth industry and look at the financial market. I sort of did a survey on each country whether the country is more a bank based financial market or a more market based which means stock market based and then as you can see 9 out of 10 the growth industry, there is a higher growth rate in a country where the funding is done through the capital market rather than the bank. It is natural outcome if you know any fundamental ideas between the risk and return. All this new growth industry has a high risk, and then the bank cannot take such high risk by its nature. So when there is a capital market that is willing to take a higher risk that will certainly produce higher return for the new growth industry.

Corporate governance I mean this again this again simple link between two variables, the quality of corporate governance surveyed by the world economic forum and the country competitiveness score produced by the Institute of management government. Even you know there are many other factors that should affect the country competitiveness, there certainly is a link between the quality of corporate governance and the competitiveness. Okay, let me conclude by looking at, we do know that Asia is not playing well in practicing good corporate governance, which is essentially important in inducing the foreign investment as well as the domestic investment. In Korea, we are now experiencing the unique situation in stock market investment. The locals are not investing in the Korean companies. The better the company the less the Korean investors are putting their money in. which means the foreigners are putting more money in the good performing Korean companies. So many of the large Korean companies, more than 50% of the stocks are in the hands of the foreigners. And there are some anti-foreign sentiments in the fear on the foreign investors taking over the management. Then, I should raise the question why the Koreans are not putting their money in the equity of these well performing companies. Probably because they have less confidence over whether their money will be protected, than the foreigners. We should definitely improve the corporate governance not just in Korea but also across all the Asian regions except a few economies.

My suggestion is government should introduce more direct regulation not indirect regulations. But that's not going to be enough. They should enforce those regulations if it is once introduced. And also there's got to be a definite improvement in the legal system. I do find there are some countries where the prosecutors and the judge are not independent from the political inference or they are not really acting in the best interest of the public. And that's quite an enigma for the region. It would be great if we see the management of the large corporation voluntarily adopt the global standard but that's not happening and we should also nurture the new institutional investor, which will take proactive rolls for the interests of the investors who had put their money in those institutions. Let me show a couple more slides on how the Asia has changed. On this chart before the 1997 crisis there are only 2 countries, which had adopted audit committees systems in Asia, which are Malaysia and Singapore. And the Hong Kong, Singapore and Malaysia had adopted the so-called independent outside directors system but now every each of the country in the list has the system of the outside director as well as the audit committee. And let me show my recent survey on these 9 East Asian countries. Okay. Let me start with the red graph. The red one we surveyed on the corporate governance regulations using the OECD corporate governance principles. We had about 100 questions and then we scored those questions from 1 to 10 scales. What it shows is China and Philippines scored highest in terms of regulation. Rest of the countries, they are about the same. Their scores are not statistically different. So now there are sort of the convergences in terms of regulation on corporate governance in Asia and China and Philippines did quite well introducing the regulation. But then the blue chart is the perceptions of investors on the quality of corporate governance on those countries. As you can see even though China and Philippines did the best job in introducing new regulation, investors' perception on the quality of the corporate governance practices lowest among the countries. In fact, China Philippines and Indonesia did not sort of do well and Singapore and Hong Kong did quite well. What this survey shows is introducing the new regulations is not enough. We have to enforce it and the market do tells that we need to not just having the new regulations but also enforcing those regulations in the market. Thank you. That's my presentation.

# Corporate Governance and Competitiveness

Hasung Jang

Dean
Korea University Business School

Asian Institute of Corporate Governance

## Opacity Index by PWC Jan.2001

35 Countries Surveyed

Country O-Factor Opacity Risk Premium(Basis Points)

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Singapore** | **29** | **0*** | **Egypt** | **58** | **572** | **Guatemala** | **65** | **749** |
| **USA** | **36** | **0*** | **Lithuania** | **58** | **584** | **Thailand** | **67** | **801** |
| **Chile** | **36** | **3** | **S. Africa** | **60** | **612** | **Ecuador** | **68** | **826** |
| **UK** | **38** | **63** | **Japan** | **60** | **629** | **Kenya** | **69** | **848** |
| **Hong Kong** | **45** | **233** | **Colombia** | **60** | **632** | **Czech Rep** | **71** | **899** |
| **Italy** | **48** | **312** | **Argentina** | **61** | **639** | **Romania** | **71** | **915** |
| **Mexico** | **48** | **308** | **Taiwan** | **61** | **640** | **Korea** | **73** | **967** |
| **Hungary** | **50** | **370** | **Brazil** | **61** | **645** | **Turkey** | **74** | **982** |
| **Israel** | **53** | **438** | **Pakistan** | **62** | **674** | **Indonesia** | **75** | **1,010** |
| **Uruguay** | **53** | **452** | **Venezuela** | **63** | **712** | **Russia** | **84** | **1,225** |
| **Greece** | **57** | **557** | **India** | **64** | **719** | **China** | **87** | **1,316** |
| **Peru** | **58** | **563** | **Poland** | **64** | **724** | | | |

## Corporate Governance Index

World Economic Forum 2003

**49 Countries Surveyed**

| Rank | | Score |
|---|---|---|
| 1 | United Kingdom | 6.34 |
| 8 | Singapore | 5.91 |
| 13 | Hong Kong | 5.59 |
| 21 | Malaysia | 5.27 |
| 23 | Taiwan | 4.96 |
| 28 | Thailand | 4.72 |
| 31 | Japan | 4.59 |
| 32 | India | 4.59 |
| 33 | Korea | 4.59 |
| 41 | Pakistan | 4.06 |
| 43 | Philippines | 3.89 |
| 44 | China | 3.80 |
| 46 | Indonesia | 3.62 |

## CLSA Corporate Governance Score:

2004

| | Score | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|---|
| Singapore | 7.5 | 7.9 | 6.5 | 8.1 | 9.5 | 5.8 |
| Hong Kong | 6.7 | 6.6 | 5.8 | 7.5 | 9.0 | 4.6 |
| India | 6.2 | 6.6 | 5.8 | 6.3 | 7.5 | 5.0 |
| Malaysia | 6.0 | 7.1 | 5.0 | 5.0 | 9.0 | 4.6 |
| Korea | 5.8 | 6.1 | 5.0 | 5.0 | 8.0 | 5.0 |
| Taiwan | 5.5 | 6.3 | 4.6 | 6.3 | 7.0 | 3.5 |
| Thailand | 5.3 | 6.1 | 3.8 | 5.0 | 8.5 | 3.5 |
| Philippines | 5.0 | 5.8 | 3.1 | 5.0 | 8.5 | 3.1 |
| China | 4.8 | 5.3 | 4.2 | 5.0 | 7.5 | 2.3 |
| Indonesia | 4.0 | 5.3 | 2.7 | 3.8 | 6.0 | 2.7 |

(1) Rules & Regulations (2) Enforcement (3) Political/ Regulatory environment (4) Adoption of IGAAP (5) Institutional mechanisms & CG culture

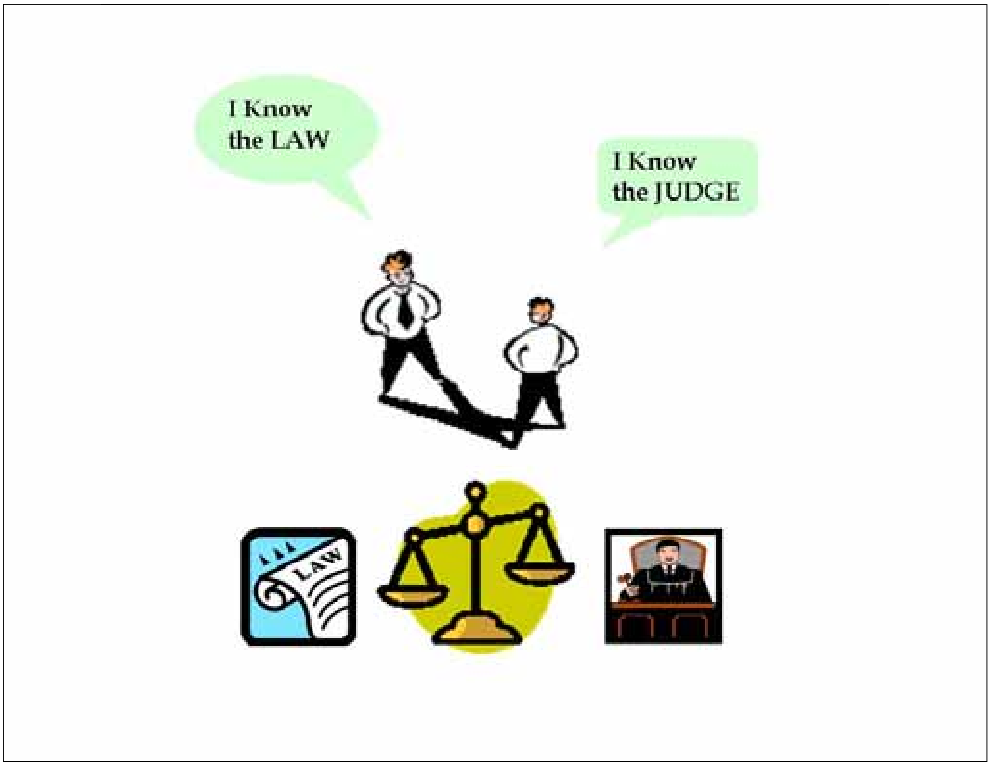
# IMD Country Competitiveness

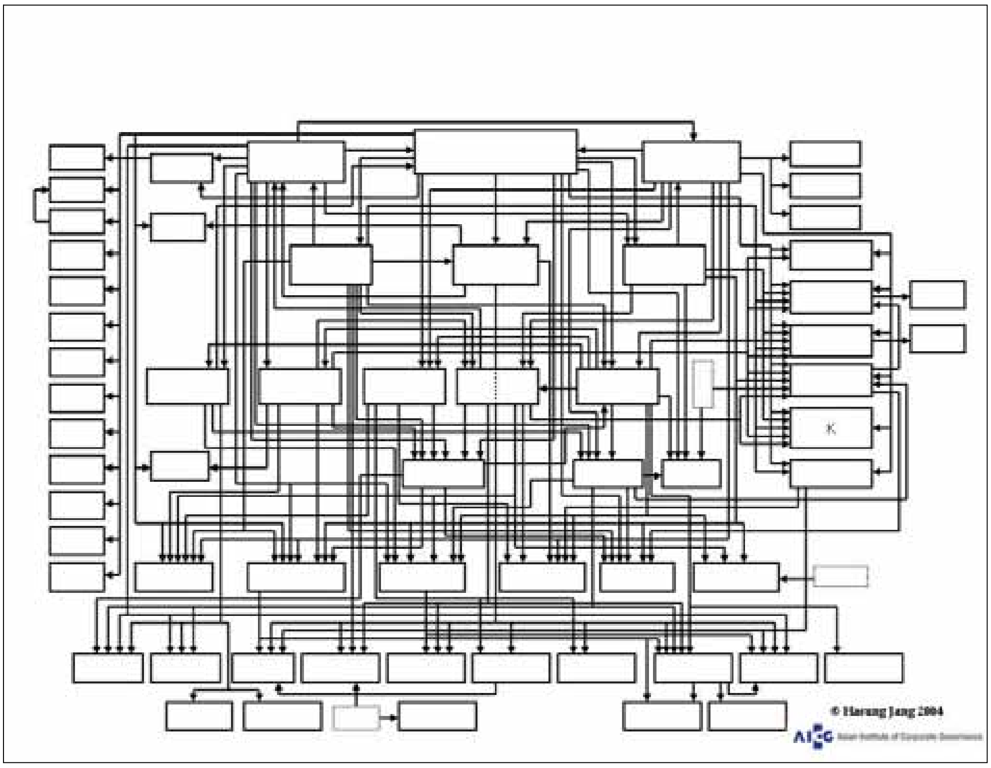
## Corporate Governance Factor Ranking, 2004

| | 기업지배구조 종합순위 | Corporate Board | Shareholder Value | Insider Trading | Shareholder Right |
|---|---|---|---|---|---|
| Singapore | 4 | 5 | 13 | 3 | 9 |
| Hong Kong | 13 | 9 | 8 | 22 | 25 |
| Malaysia | 15 | 10 | 12 | 25 | 18 |
| Taiwan | 28 | 12 | 21 | 34 | 28 |
| India | 39 | 29 | 35 | 49 | 35 |
| Thailand | 41 | 27 | 28 | 55 | 39 |
| China | 46 | 25 | 40 | 57 | 44 |
| Japan | 47 | 50 | 59 | 13 | 59 |
| Philippines | 50 | 37 | 42 | 54 | 50 |
| Korea | 54 | 53 | 53 | 41 | 55 |
| Indonesia | 59 | 56 | 52 | 59 | 54 |

# Why Poor Corporate Governance in Asia?

- Establishments' rent seeking behavior
- Concentrated ownership
  - Pyramidal or circular ownership
- Weak protection of shareholders
  - Expropriation of minority shareholders
- Shareholders are inactive
  - Institutional investors are passive and dependent on industrial companies
- Enforcement of regulation is weak
- No independent monitoring mechanism


I Know
the LAW
I Know
the JUDGE
LAW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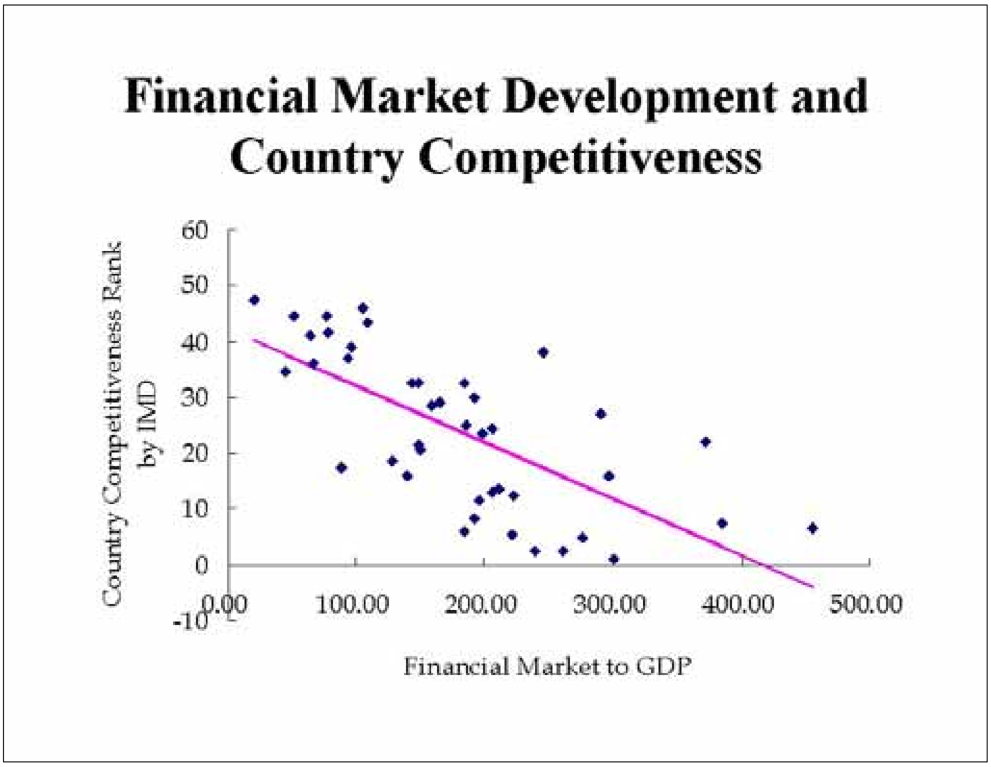
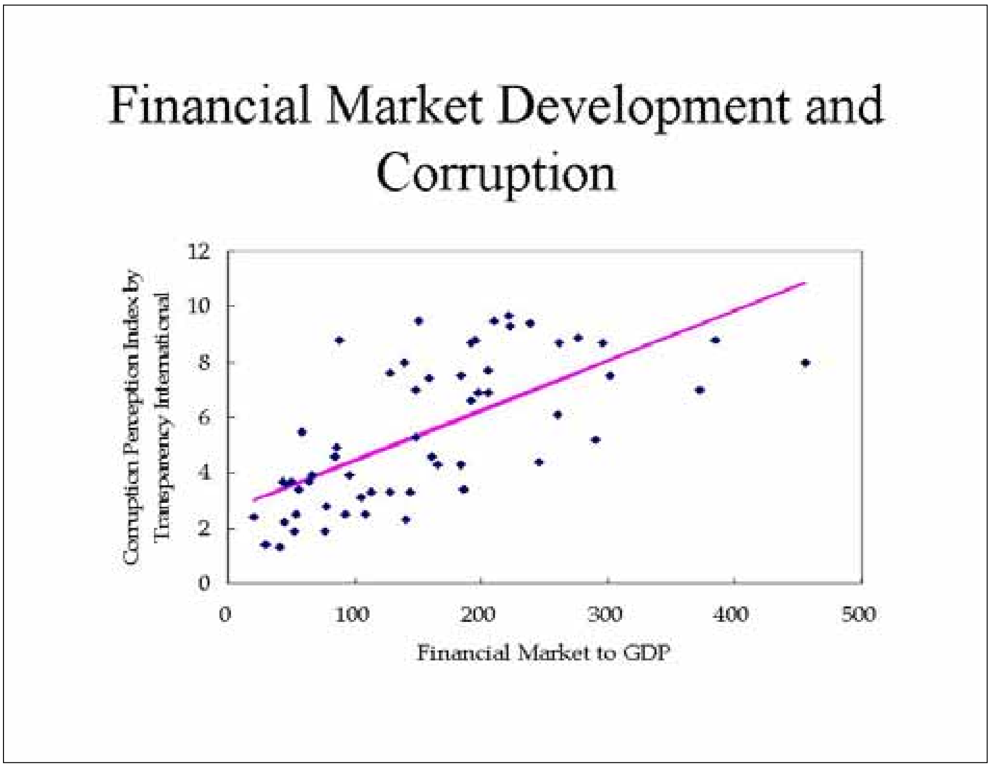
© Harang Jang 2004


Financial Market Development and Country Competitiveness
Country Competitiveness Rank by IMD
60
50
40
30
20
10
0
-10
0.00
100.00
200.00
300.00
400.00
500.00
Financial Market to GDP


Financial Market Development and Corruption
Corruption Perception Index by Transparency International
12
10
8
6
4
2
0
0
100
200
300
400
500
Financial Market to GDP

## Future Growth Industry and Financial Market

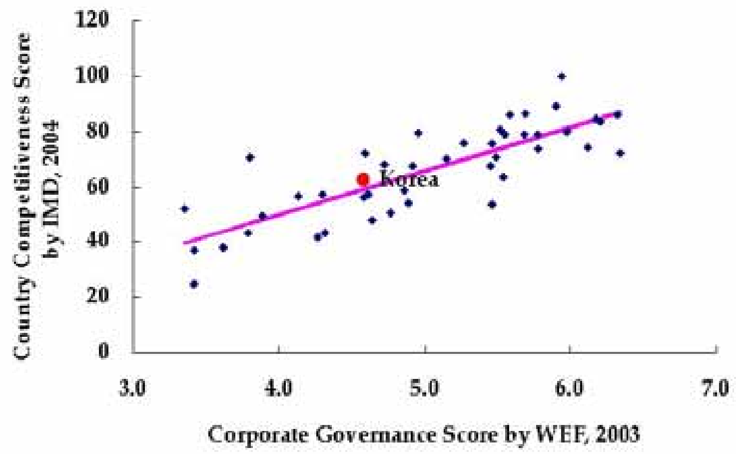
Annual Growth Rate of Real Value Added (%) (1991-2001)

| Industry | ISIC | Bank-based | Market-based | Dominance |
|---|---|---|---|---|
| Digital TV/Broadcast | 32+64 | 1.94 | 3.84 | Market-based |
| Display Device | 26+30+32 | -0.22 | 1.43 | Market-based |
| Intelligent Robotics | 29+31+32 | 0.69 | 3.18 | Market-based |
| Future Automobile | 30+34 | -0.92 | 1.12 | Market-based |
| Next G Semi-conductor | 30+32 | -0.93 | 1.42 | Market-based |
| Next G Mobile Telecom | 33+64 | 1.97 | 2.55 | Market-based |
| Digital Contents | 64+72 | 6.47 | 7.85 | Market-based |
| Next G. Battery | 31+32 | 0.53 | 3.45 | Market-based |
| Bio Pharmaceuticals | 33+24 | 1.45 | 1.76 | Market-based |
| Average | | 1.22 | 2.96 | Market-based |

Data: OECD STAN database, World Bank WDI, B. Shin & et al (KSRI)

## Corporate Governance and Country Competitiveness

45 Economies



## What Will Expedite Changes?

- Government
  - More direct regulations on corporate governance
  - Enforcement of regulations
- Legal System
  - Fair and effective court system
  - Fair and independent prosecution
  - Security class action suit

## What Will Expedite Changes?

- Corporation
  - Voluntary adaptation of global standard
  - Active independent outside directors
- Market
  - Pro-active role of institutional investors
  - Active participation at shareholder's meeting
- Civil Society
  - Participation in policy making: NGOs
  - Minority shareholder activist watch dog

# Changes in Corporate Governance Regulation in East Asia

### Asian Corporate Governance Association, 2004

EXHIBIT 1

**Asia steps up**

Independent director and audit committee requirements

| | 1997 | | 2003 | |
|---|---|---|---|---|
| | Independent directors? | Audit committees? | Independent directors? | Audit committees? |
| China | | | ✓ | ✓ |
| Hong Kong | ✓ | | ✓ | ✓ |
| India | | | ✓ | ✓ |
| Indonesia | | | ✓ | ✓ |
| Malaysia | ✓ | ✓ | ✓ | ✓ |
| Philippines | | | ✓ | ✓ |
| Singapore | ✓ | ✓ | ✓ | ✓ |
| South Korea | | | ✓ | ✓ |
| Taiwan | | | ✓ | ✓ |
| Thailand | | | ✓ | ✓ |

Source: Asian Corporate Governance Association

# Corporate Governance Regulation Scoring

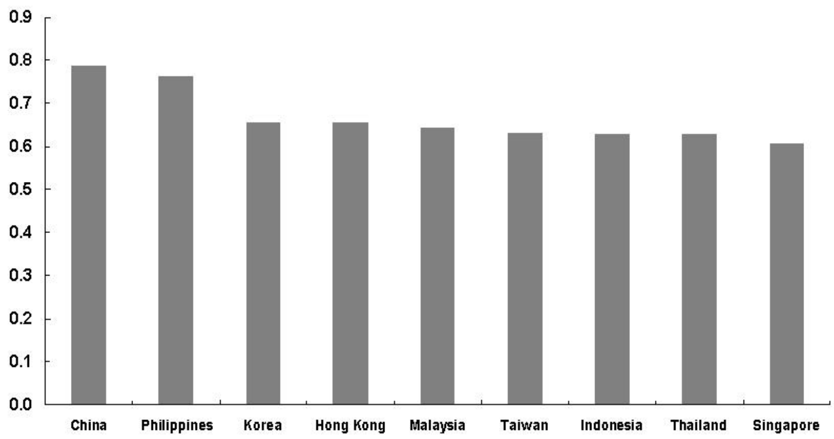
9 East Asian Economies, PECC project in 2005

- OECD Corporate Governance Principle
- 55 questions are used in scoring
- Five areas of corporate governance
  - Rights of shareholders
  - Equitable treatments of shareholders
  - Role of stakeholders
  - Disclosure and transparency
  - Board responsibilities

## Corporate Governance Regulation Scoring

9 East Asian Economies, PECC project in 2005

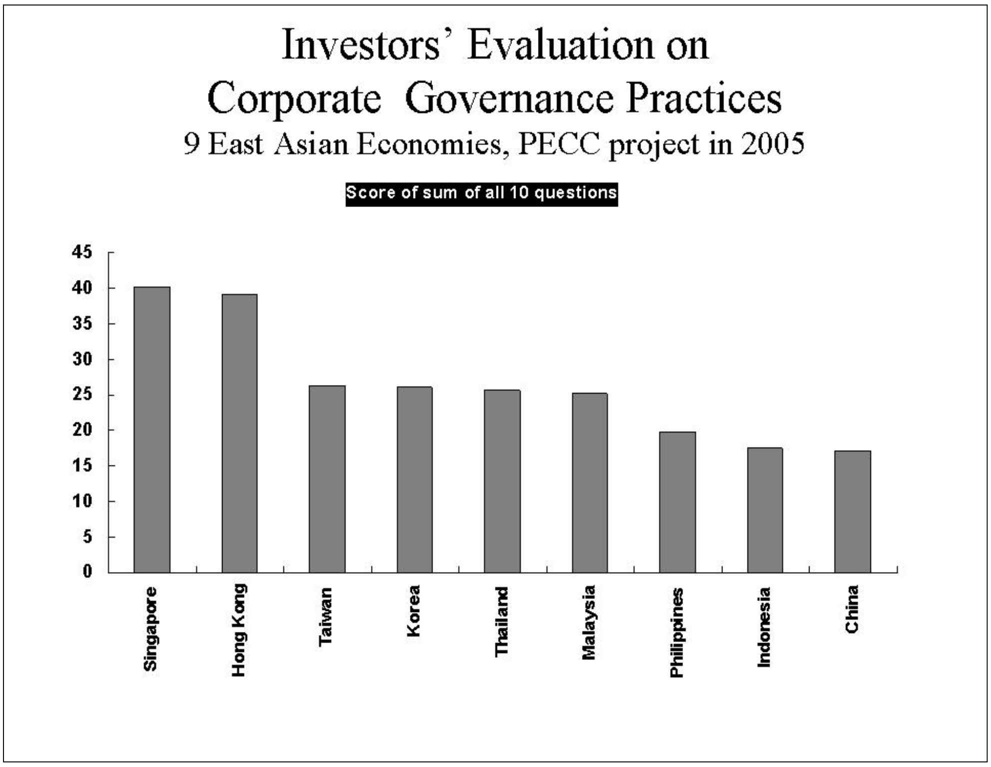
**Rating result (Weighting 1)**




## Investors' Evaluation on Corporate Governance Practices

9 East Asian Economies, PECC project in 2005

1. How do you evaluate overall quality of corporate governance practiced in each county?
2. Shareholder rights are protected.
3. Management respects shareholder value.
4. Accounting reports including annual and semi-annual reports are accurate and reliable.
5. Disclosures are made timely and adequately.
6. Board supervises the management independently and effectively.
7. Rules and regulations on corporate governance are enforced effectively.
8. The financial intermediaries including accountants and auditors can be trusted.
9. Legal system including courts and prosecutors are fair and independent.
10. Foreign investors are equally treated as local investors.

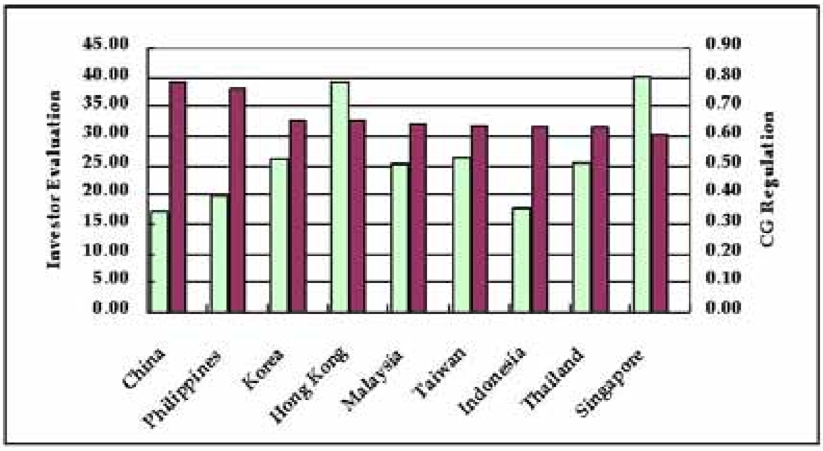



## Corporate Governance Scoring on 9 East Asian Economies PECC project in 2005

| | Regulation | Investor Evaluation |
|---|---|---|
| China | 0.79 | 17.03 |
| Philippines | 0.76 | 19.75 |
| Korea | 0.66 | 26.11 |
| Hong Kong | 0.66 | 39.24 |
| Malaysia | 0.64 | 25.25 |
| Taiwan | 0.63 | 26.26 |
| Indonesia | 0.63 | 17.60 |
| Thailand | 0.63 | 25.64 |
| Singapore | 0.61 | 40.18 |

Corporate Governance Regulations and Investor's CG Evaluation

9 East Asian Economies PECC project in 2005




Thank you!

# Corporate Governance for Investment

***Mats Isaksson***
Head
Corporate Affairs Division, OECD

Thank you very much and I'm extremely happy not to be alone up here that together with an excellent panel of some old and new friends. To my left we have Mr. Marut, who said I could actually it's enough if I said Marut because I can't pronounce his last name properly anyway from vice president of the Corporate Business Development of PTT Public corporation in Thailand. And to my immediate left is Mr. Hasung Jang who is the recently appointed dean of the business group of the Seoul National University, Korea University, there's a big problem between them two. I also have professor Curtis Milhaupt who definitely is with Columbia University in New York City. And I have Mr. Pierre Habbard to my far right who is from the trade Union Advisory Committee to the OECD. And they will all come back with their interventions later after I have made a 5-minute introductory remark to this issue of corporate governance and investment. I would like to rewind the tape a bit and remind you that the very first steps that the OECD took in the area of corporate governance were a project that was labeled access to capital and that was sort of the entry point of the OECD into the issue of corporate governance. Access to capital in a world where capital is increasingly mobile and where national circumstances are judged on a global basis.

This work in turn inspired the development of the OECD principles of corporate governance that was issued in the late 1990s and quite rapidly actually became somewhat of a benchmark for corporate governance around the world. In the wake of the financial crisis the OECD principles of corporate governance were also adopted as one of the 12 key standards by the financial stability forum to monitor the international financial architecture. That means that the OECD principles of corporate governance is also the benchmark against the fund and the World bank that they use in their reports on the observance of standard and codes around the world and in the area of corporate governance it's the principles that underlying standard. But all those things are formality in a sense and less important than the actual contents of these principles and their link I should say to the issues we're discussing today, namely investment. We have excellent scholars and petitioners up here today that will give you concrete examples of what this link actually looks like. But from my very rough perspective I would like to link it to the investment process. And I would like to segment investment process if you want to investment process into different stages very roughly you have at the beginning of the process you have to actually accumulate the capital. You need to make sure that money is taken out of the mattresses and actually put into productive use. At the second stage of the investment process, you have to make sure that the capital is allocated to the best possible use among competing alternatives, and at the third stage of investment process you have to make sure you can actually monitor the use of those investments once they are made. The OECD principles of corporate governance as corporate governance in general I would say addresses the specifically all the different stages of this investment process. At the very first stage for example issues such as investor protections, the right to dividends, the rights to redress, are all rule of very basic concepts of the rule of law that needs to be in place in order for people to actually venture into an equity investment. At the second phase the allocation, the issue of disclosure if of course essential. How will you be able and how will the market be able to allocate capital without proper understanding of the prospects of the various investment opportunities.

There is an entire chapter in the OECD principles on disclosure and transparency for exactly that reason. And at the third stage when it comes to monitoring the company the balance of power between the company organs such as the shareholder meetings, the board of directors, and the managers is of course at the heart of what corporate governances is all about. As I said the OECD principles I think met a quite a demand when they first came out and we have now revised them, we did that in 2004, in the light of Enron and Parmalat and world com you name them, and I'm sure there will be a revision down the line as well because this is by all means, an evolving issue. I don't think we'll ever come to a stage of regulation or practices where we can say we have achieved the perfect system of corporate governance. It will revolve over time as company change, as investors change, and as competitive circumstances change. All of these things must be taken to account. That's why the OECD principles is not a binding instrument it's supposed to be a living instrument that have also overtime adjusts to the needs of business and to our economies. There's been one little hole we've been trying to plug, so to speak over the last couple of years. Because we have realized that in a number of economies, the government still places an important role in the business sector and it plays a role in important areas for example in the utilities industry and infrastructure industry, industries that are important for the productivity and the efficiency of also of other sectors of the economy. Also incredibly important for the supply of everyday needs of citizens are such as water and electricity and you name it. And that was an underlying reason why the OECD member countries recently agreed on a new and complementary set of principles of corporate governance of state owned enterprises. Theses guidelines have met tremendous interest particularly in a lot of non-OECD countries where these sectors are of considerable size. And I will come back in the discussion to their specific content but I would also like to underline that the purpose of these guidelines is not by any means to prevent or to preempt any attempt of privatization. I shouldn't say on the contrary but equally possible these guidelines have been seen as a way to facilitate successful privatizations in those cases where countries have privatization plans in place because the obvious arguments that if your companies are in good shape in terms of corporate governance it will not only be easier to find a buyer for them but you will also be able to catch a higher price for the assets once you sell part of it or the whole company to the market. So that's a short introduction and a little bit of background story of where the OECD enters the work of corporate governance and how we see the link between corporate governance and investment. We have as I said before we had prominent scholars and petitioners here that have done that have done more particular work on this link and particularly Hasung and Curtis who has done papers on these issues. So I think I'll start the discussion by giving the word to Professor Hasung Jang to give his perspective, thank you.

# Corporate Governance and FDI: Comments on the Asian Experience

***Curtis J. Milhaupt***
Professor
Columbia University, U.S.A.

## Introduction

East Asia is characterized by a diverse form of corporate structures and practices, although several stylized facts are broadly applicable to most systems in the region: relatively concentrated share ownership and the presence of minority controlling shareholders or group-based shareholding patterns, family-based corporate ownership, and concern for a range of "stakeholders" (especially employees) broader than the Anglo-American focus on shareholder wealth maximization. As a region, East Asia has been the recipient of large inflows of foreign direct investment (FDI). China in particular has seen a rapid growth in FDI and is today the world's number one recipient of FDI.

This report will examine the link between corporate governance and foreign direct investment (FDI), using the recent experience of East Asian countries for purposes of illustration and analysis. In overview, the report will examine the implications of East Asian corporate structures and practices for FDI-related economic growth. In order to begin understanding those implications, we must first ask whether corporate governance matters to FDI, and if so, how? A second step in the analysis is to evaluate recent corporate governance reforms in East Asia. Recent reforms in Japan, South Korea, and China all focus on the board of directors, particularly the use of "outside" or independent directors. As we will see, the influence of the United States is prevalent in these reforms. How should we expect these reforms to function in a diverse range of systems, whose corporate governance issues may or may not resemble those of the United States, where the reforms initiated? Can we anticipate a favorable impact on FDI as a result of these reforms? Finally, the report will raise several issues that deserve additional research and exploration by scholars and policymakers interested in the role of corporate governance in FDI decisions in the Asian context.

### *1. East Asian Corporate Governance and Its Implications for FDI*

Corporate governance structures and practices in East Asia are highly diverse. Thus, no brief summary can do justice to the topic. However, several stylized facts about common governance traits can be presented here in order to begin considering the potential impact of Asian corporate governance on FDI decisions.

First, share ownership in Asian countries does not fit the dichotomy typically presented in the academic literature between concentrated and dispersed share ownership regimes. For example, the dominant share ownership structure in Korea is the controlling minority shareholder (CMS) model. Through pyramids and circular stock ownership patterns, founding shareholders are able to multiply their voting rights and retain control of group firms despite relatively low levels of equity ownership. Share ownership in Japan is dispersed, but more concentrated than in the United States. Second, Asian countries are characterized by group-based corporate structures. This is true of virtually every economy in Asia—from the Korean *chaebol* and the Japanese *keiretsu*, to Taiwanese and Thai corporate groups. While the historical formation and precise structures of the groups differ from country to country, they share a basic feature: cross share ownership among affiliated firms. In most countries, the groups were founded by entrepreneurial families, often with assistance or backing from the government. Family orientation remains strong in some systems (e.g, Korea) but has faded in others (e.g. Japan). Third, in contrast to the relatively single-minded focus on shareholder wealth maximization in Anglo-American systems, East Asian corporations are run for the benefit of a broad range of stakeholders, particularly employees. While shareholders' interests are not ignored, and indeed seem to be gaining in importance in Asia, managers conceive of their primary role as providing for continued employment and continued existence of the firm. Finally, East Asian legal systems share the German civil law heritage. As such, the structure of their corporate codes, which provide for shareholders rights and key corporate governance organs, share some basic similarities. Partly as a result of all of these features, capital markets have traditionally played a smaller role in Asian corporate governance and finance than in the Anglo-American systems. This is quite consistent with the Western European experience.

What are the implications of the corporate governance features just described? Several implications with possible relevance to FDI can be mentioned. First, mergers and acquisitions are comparatively more difficult and expensive. Japan illustrates this very vividly. In 1990, Japanese merger activity was only 0.4 percent of GDP (by comparison, the U.S. figure was 1.8 percent). In 1997, Japan had only a 0.6 percent share of the global takeover market. Even as late as 1998, Australia's M&A market was twenty times larger than that of Japan. (Milhaupt and West 2003). A second implication of East Asian corporate governance systems is that external (shareholder) monitoring of firms is comparatively difficult. This is because group enterprise structures are complex and a high degree of firm-specific information is located within the group, while boards of directors have not traditionally contained outside members. Moreover, relationships among numerous affiliated firms increase the opportunities for insiders to engage in transactions beyond the monitoring capabilities of minority shareholders (Khanna & Palepu 2000). In extreme form, exploitation of minority shareholders (known in the literature as "shareholder tunneling") becomes widespread. A more subtle problem is also possible, even in corporate governance systems such as Japan's, where minority shareholder expropriation is not a serious problem. This is the possibility that managerial concern for stakeholders can serve to entrench management and erode financial returns to shareholders. I call this phenomenon "stakeholder tunneling." Stakeholder tunneling occurs when managers pursue negative net present value projects in order to expand market share or to stave off financial restructuring—principally so as to ensure continued employment for their workers and themselves at the expense of shareholder returns.

### 2. *How Important is Corporate Governance to FDI Decisions?*

Having briefly sketched out some stylized facts, we now are in a position to assess, however tentatively, the possible implications of Asian corporate governance for FDI. To begin, we must address the threshold question of whether corporate governance matters to FDI. To state the conclusion at the outset: corporate governance does seem to matter, but how much and in precisely what ways is still not well understood. The recent success of China in attracting FDI despite serious shortcomings in corporate governance highlights these uncertainties.

Investors clearly believe that corporate governance matters. In a recent survey, 30 percent of global investors said that corporate governance issues are the most critical business risks. Twenty-eight percent cited corporate governance as the global development most likely to influence FDI decisions (Kearney 2004). Moreover, institutional investors consistently say they are willing to pay a premium to own shares in well-governed firms. The premium averaged 22 percent in Asia (McKinsey 2002).

Academic research supports these survey results. For example, a study by Black, Jang and Kim (2004) shows that well-governed Korean firms trade at a big premium to poorly-governed firms. These results are apparently not limited to transition or developing economies. A study by Grandmont et al. (2004) indicates that well-governed companies in the S&P 500 outperformed poorly governed firms by 20 percent over a two-year period. Nam & Nam (2004) provide extensive additional evidence that corporate governance improves firm value.

China, however, seems to pose a problem for these results. For the past several years, China has been the number one recipient of FDI in the world. China rates a 2.03 (out of 3) on the FDI confidence index. By comparison, the United States rates 1.45, Malaysia 0.92, South Korea 0.85, and Indonesia 0.80 (Kearney 2004). Yet it is widely acknowledged that

China faces serious corporate governance challenges. These include poor managerial and accounting practices, weak minority shareholders rights, and widespread financial irregularities. Moreover, China's capital markets, corporate and securities laws, and judicial system are all at early stages of development. Given these problems, China rates near the bottom on various corporate governance indices (e.g. Asian Corporate Governance Association (2005), rating China's "corporate governance culture" 2.3 on scale of 10). Simply put, if corporate governance matters to foreign investors, how can we explain China's tremendous success at attracting foreign investment?

### *3. How Does Corporate Governance Matter to FDI Decisions?*

The China puzzle forces us to consider the question of *how* corporate governance may matter to FDI decisions. This is a difficult question, and it is fair to state that no solid answers have been provided by the academic literature to date. As a theoretical matter, good corporate governance could provide a range of distinct benefits to foreign investors. For example, good corporate governance may increase firm value. That is, it may *maximize* distributions to investors. That appears to be the thrust of the academic studies cited above. But good corporate governance may also protect minority investors from exploitation by controlling shareholders (*securing* distributions). Another possibility is that good corporate governance lowers the probability of a scandal that could jeopardize the firm's continued existence (think of Enron in the United States, Zhen Baiwen in China, Seibu in Japan, or Daewoo in Korea). Finally, good corporate governance may be a sign of good institutions generally. This last possibility is consistent with a recent report of the Asian Development Bank (2004), which concludes that a host country's general commercial environment is the most important factor in FDI. Again, these are *theoretical* possibilities. Academic research, at least, has not demonstrated a clear link--robust across many systems--between good corporate governance and these possible benefits. Much more research into this question is needed.

Whatever the precise contributions of good corporate governance to FDI decisions, it is important to recognize that investors often provide substitutes for the protections sometimes provided by good corporate governance. Where institutional environments are under-developed and corporate governance practices are weak, foreign investors are likely to engage in green field investment and work with trust local partners, typically in joint-venture form. They also resort to contractual protections such as foreign arbitration of disputes and pursue non-equity forms of involvement in the host economy, such as through licensing deals. The obvious strategy behind all of these forms of investor self-help is to reduce exposure to the risks of minority shareholder status in a poor corporate governance environment.

The impact of the quality of corporate governance on FDI is most apparent in the mode of entry foreign investors use to gain access to the host country. In all developed economies, mergers and acquisitions are the principal vehicle for FDI. By contrast, in emerging markets, green field investment and joint ventures dominate (World Investment Report 2005). M&A is used much less frequently by foreign investors seeking to enter developing economies because of a lack of suitable acquisition targets and because the institutional environment for such transactions is immature.

Now return to the China puzzle. With the help of the analysis above, China's experience actually confirms the importance of corporate governance to FDI. Obviously, China has attracted FDI because of its tremendous growth potential. But China's corporate governance climate has affected the pattern of investment. For example, it is clear that foreign investors, responding at least in part to a poor corporate governance climate, have taken self help measures to secure their investments. Wholly owned foreign enterprises (such as green field investments) accounted for almost 75 percent of FDI in 2004 (US-China Business Council 2005). Joint ventures with a local partner accounted for 25 percent of FDI. Less than 1 percent of all FDI into China was in the form of shareholding ventures. While corporate governance concerns clearly are not the only factors that determine FDI structures, these data strongly suggest that foreign investors have avoided investing in vehicles that would expose them to corporate governance risk. Also recall the point above that M&A is the major vehicle for FDI in developed economies. In China, M&A accounted for only 5 percent of FDI in the late 1990s. Today, acquisitions of, and equity participation in, Chinese ventures are beginning to accelerate along with China's gradual institutional and market maturation, but they are still considered high risk investments. Thus, corporate governance factors actually help to explain the pattern of FDI in China. Moreover, they suggest that there may be an "FDI life cycle"—dependent upon the corporate governance climate and degree of institutional development in the host country--that begins with green field investment and licensing deals, moves into joint ventures and portfolio shareholding, and culminates in mergers and acquisitions.

One policy lesson that can be taken from this brief analysis is that corporate governance structures and practices conducive to M&A create opportunities for foreign investors. Similarly, an institutional environment for M&A (both friendly and hostile) contributes to an attractive environment for FDI. Japan's experience provides strong confirmation of this point. In the postwar period, cross-shareholding structures, insular management practices (involving promotion almost exclusively from within the firm and with more emphasis on seniority than performance), and an inefficient legal environment for M&A suppressed FDI despite the rapid growth of the economy. Indeed, Japan had one of the lowest rates of inward FDI of any industrialized country in the 1970s and 1980s. Since the late 1990s, however, and based on an explicit FDI promotion policy of the government, better corporate governance and more efficient M&A rules have contributed to increased FDI.

Today, Japan faces a major policy issue related to hostile acquisitions. A recent series of hostile bids (mostly by Japanese firms) has led to anxiety among the business community about the "vulnerability" of Japanese companies to foreign acquisition. In response, the Ministry of Economy, Trade and Industry and the Ministry of Justice promulgated Takeover Guidelines in May of 2005. The Guidelines, which are heavily influenced by Delaware judicial doctrine, authorize the use of shareholder rights plans ("poison pills") as a defensive measure. As an initial matter, the foreign investment community has taken a negative view of this development. The criticism is that Japanese managers do not pay adequate attention to shareholder interests, most boards lack truly independent directors, and the corporate governance climate is too deferential toward management. Thus, according to this criticism, a powerful device like the poison pill is not appropriate in Japan, because the corporate governance climate is already unfavorable to unsolicited bids. Foreign investors fear that managers will simply use poison pills in place of cross-shareholding arrangements, and Japanese firms will once again become invulnerable to takeovers. The counter to this criticism is that the Guidelines clarify the circumstances under which defensive measures are appropriate, placing heavy emphasis on shareholder approval and enhancement of corporate value. There is evidence that the Guidelines are shaping a consensus that managers must respond to hostile bids in the interest of their shareholders and corporate value as a whole. Regardless of which view is ultimately proven correct, the Japanese experience throughout the postwar period highlights the importance of M&A policy to FDI.

### 4. *Recent Corporate Governance Reforms in East Asia*

In this section of the report we will briefly examine a series of recent corporate governance reforms taking place in several East Asian countries, and consider their possible impact.

Corporate reforms in several East Asia over the past five years have had a common theme: board reform and outside directors. In Korea, since 2000 large listed companies must have an audit committee composed primarily of outside directors. Half the board of listed firms must consist of outside directors. In Japan, since 2004 large firms have the option of eliminating their statutory auditor regime (a transplant from German corporate law) and establish independent committees for audit, compensation and nomination. Each of the committees must have a majority of outside directors. And in China, a variety of stock exchange rules and CSRC regulations require listed companies to have independent directors. U.S. experience has influenced each of these reforms, at least to some extent.

Particularly after the passage of the Sarbanes-Oxley Act, attention in the U.S. has been focused on the board of directors—particularly the independent audit committee of the board—as the key monitor in corporate governance.

Will these reforms across Asia improve corporate governance and provide additional confidence to foreign investors in these markets? Comparative corporate governance scholarship suggests that the answer will depend largely on both the legal definition of "independence" and the surrounding institutions in each jurisdiction. The role of independent directors in these separate regimes is likely to vary substantially. Return to our theoretical analysis of how corporate governance may matter to FDI. In a system such as Korea's, where the major issue is protection of public minority shareholders from abuse by controlling minority shareholders, independent directors in theory can play a role in ensuring more transparent and arms-length transactions between affiliated firms under the common control of a controlling minority shareholder. In Japan, with its potential stakeholder tunneling problems of low return on assets (ROA) and equity (ROE), independent directors could provide truly "outside" perspectives on business decisions that are not tied to traditional cultural priorities. In a system like China's, with a high degree of potential state involvement in corporate decisions, perhaps independent directors can serve as a line of defense against financial fraud and a voice for public shareholders. The definition of "outside" or "independent" director also varies greatly from country to country. In Korea, it means a non-full time director. Thus, the definition turns on the amount of time devoted to the position rather than the characteristics of the person filling the position. In Japan, it means a director who has never been an employee of the firm or one of its subsidiaries. This means that a director affiliated with a parent company or controlling shareholder would qualify as an outside director. In China, the definition of independence is vague and permits politically appointed directors. So far, outside the Korean context (see Black, Jang and Kim 2004), there is not much evidence that the board reforms and outside/ independent director movements in these countries are having a major impact on corporate governance (for Japan, see, e.g., Gilson & Milhaupt 2005; for China, see Clarke 2005). Most likely, the impact on FDI will be highly dependent on whether the U.S.-inspired reforms are integrated into a larger set of complementary institutional reforms or simply adopted in a formalistic way.

### 5. *Future Research and Policy Agenda*

This brief analysis has suggested that several aspects of corporate governance prevalent in Asian systems pose special problems for investors. Many issues are presented for further research and policy analysis. For example, given the relatively more difficult monitoring environment posed by Asian corporate governance practices, more attention should be given to the role of institutional investors in corporate governance. What little research on the topic is available suggests that institutional investors are better equipped than other investors to monitor non-transparent group structures (Khanna & Palepu 2000). Although the situation appears to be changing, thus far, institutional investors have not been particularly active in Asian corporate governance. Yet institutional investors may have particular potential in Asia given the relational nature of their investments.

Another area of potentially fruitful research and policy consideration is the role of "gatekeepers" in Asian corporate governance. Gatekeepers are accountants, lawyers, underwriters, credit rating agencies, and stock analysts—professionals who lend their expertise and reputation to enhancing the accuracy of corporate financial disclosures. Gatekeepers have received an extraordinary amount of attention in the United States in the wake of the Enron scandal and the passage of the Sarbanes Oxley Act. More attention could be devoted to improving the roles of these professionals in building robust disclosure regimes and providing expert, independent advice to boards of directors.

Finally, the impact of FDI on corporate governance—the inverse of the topic of this report—remains almost completely unstudied. While many studies have focused on the general impact of FDI on host economies, very few studies have examined how foreign investment affects host country business practices. A study by Ahmadjian (2004) indicates that foreign portfolio investment in Japanese firms is associated with better transparency and disclosure, increased board independence, and a propensity to downsize and divest assets. However, limitations in the design of this specific study call for further investigation of this important topic. Fully informed FDI policies should take better account of the ways in which foreign investors can be used to help improve local practices.

## Conclusion

This report has examined the impact of corporate governance on FDI decisions. Considerable evidence from both academic research and investor surveys indicates that corporate governance is a significant factor in FDI decisions. Theoretically, good corporate governance could make foreign investment more attractive on a number of levels, although not enough research has been done to establish clear empirical linkages between good corporate governance and investor protection across a variety of dimensions. At first blush, the success of China in attracting foreign investment despite serious shortcomings in corporate governance may suggest that corporate governance is not important to FDI. However, closer examination of the pattern and types of foreign investment into China actually confirm the importance of corporate governance. The postwar Japanese experience suggests that corporate governance and institutions surrounding mergers and acquisitions is a major component of an FDI policy.

Recent corporate governance reforms in several East Asian countries are superficially similar, revolving around board reform and the mandatory inclusion of outside directors on the board. However, the reforms differ in practice, because the definition of outside or independent director varies substantially, and the role to be played by outside directors in the respective systems varies significantly as well. Thus, whether or not these reforms will promote better corporate governance and increased FDI is an open question. Much will probably depend on whether complementary institutional reforms will be put in place to provide a vehicle for outside directors to actually play a role in mitigating the specific problems faced by each system of corporate governance.

Policymakers interested in improving their FDI policy have a number of important issues to consider, including the possible role of institutional investors, the role of professional outside agents such as accountants and lawyers, and the impact of foreign investors on corporate governance in the host country.

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# Part III

# APEC-OECD Cooperation

# Session 1: Rapidly Increasing Economic Integration and Investment: Benefits & Challenges

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**Presentations**

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# Bilateral Investment and Tax Treaties and FDI

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## 1. Introduction

Developing countries[22] sign bilateral investment treaties (BITs) and double taxation treaties (DTTs) in order to attract more foreign direct investment (FDI). BITs represent a non-trivial interference with developing countries' sovereignty as they provide protections to foreign investors that are enforceable via binding investor-to-state dispute settlement. While DDTs mean that developing countries succumb to restrictions on their ability to tax corporate income from foreign investors, which can only pay off if more FDI is the reward. But do BITs and DTTs attract more FDI to developing countries? This is the topic of the analysis provided here.

The preambles of the thousands of existing BITs state that the purpose of BITs is to promote the flow of FDI and, undoubtedly, BITs are so popular because policy makers in developing countries believe that signing them will increase FDI. An expected increase in FDI with respect to DTTs needs a bit of elaboration, however. Double taxation occurs if an economic agent pays tax on the same income earned from economic activity in a foreign country twice: once to the tax authorities of the foreign country, which is host to the economic activity, and once to the tax authorities of the home country, in which the agent normally resides. By burdening economic activity in a foreign country twice, double taxation can represent an obstacle or barrier to foreign investment, thus distorting the efficient allocation of scarce financial resources across countries of the world.

Despite the large and increasing number of BITs and DTTs concluded, there exists very little evidence on the question addressed by this study. This omission is strange given that the question is of great importance to developing countries. They invest time and other scarce resources to negotiate, conclude, sign and ratify BITs and DTTs. If no increase in FDI can be expected, then the effort spent concluding BITs and DTTs would be wasted and the costs imposed would fail to be recovered.

[22] For the purpose of this article, the category of developing countries refers to all countries other than the United States and Canada, Western Europe, Japan, Australia and New Zealand.

## 2. BITs, DTTs and FDI

The flow of FDI has dramatically increased in the past several decades to become a major force in the worldwide allocation of funds and technology. Prior to 1970, world trade generally grew at a greater pace than that of FDI, but in the decades since then the flow of FDI has grown at more than twice the pace of the growth of worldwide exports. By the early 1990s, the sales of worldwide exports would be eclipsed by the sales of foreign affiliates of multi-national firms (Dunning 1998). Not only has the flow of FDI increased worldwide, but the importance of FDI as a source of funds to developing countries in particular has also significantly increased. Private international flows of financial resources have become increasingly important to developing countries. In the 1980s tight budgets, the debt crisis and an overall decreased interest in providing traditional development aid lead to a decline in official development assistance from the developed world. When capital flows to developing nations began to rise again in the latter part of that decade, the flows would increasingly be composed of FDI (Zebregs 1998). Only very recently have aid flows slightly increased again in the wake of the so-called Monterrey Consensus. However, in 2003 FDI was the largest component of the net resource flows to developing countries and this is bound to remain the case for some time to come (UNCTAD 2003). Although the developed countries remain both the dominating source and the major recipient of FDI, their dominance has decreased over time with developing countries in 2003 receiving almost 31% of FDI as opposed to only about 20% in the 1980s (UNCTAD 2004). Indeed, FDI inflows per unit of GDP are much higher in many developing countries than in developed ones (ibid.). It was during this same period that DTTs between developed and developing countries proliferated and in light of the importance of FDI, particularly to developing nations, the extent to which these two phenomena are causally related warrants careful scrutiny.

In their aim to increase FDI inflows, developing countries have resorted to bilateral treaties to signal their commitment to stable, correct and often favourable treatment of foreign investors. The first BITs appeared at the end of the 1950s. Some trace their history back to the treaties of friendship, commerce, and navigation (FCN) concluded by the United States over centuries (Salacuse 1990). The FCN treaties had the expansion of international trade and the improvement of US foreign relations as their prime purpose, even though some investment provisions were later added (Guzman 1998). BITs on the other hand are more clearly focused on foreign investment protection. Germany, having lost almost all of her foreign investment during the Second World War, signed the very first BIT with Pakistan in 1959. After that, it took almost two decades before BITs gained momentum. By the end of the 1960s there were 75 treaties, which rose to 167 by the end of the 1970s and to 389 by the end of the 1980s. The number of BITs worldwide began to grow rapidly in the 1990s and by 2002 there would be 2,181 BITs worldwide (UNCTAD 2003a).

Efforts aimed at avoiding double taxation go back a long time in history and the first DTTs were concluded much before the first BITs were signed. According to Easson (2000: 619), the treaty between Austria-Hungary and Prussia from 1899 represents the first modern DTT. Multilateral organizations such as the League of Nations (and later the United Nations) and the Organisation for European Economic Co-operation (later known as the Organisation for Economic Co-operation and Development) also promoted DTTs from an early stage. Until the late 1960s, DTTs were mainly concluded among developed countries, but since then an increasing number of treaties has been concluded between developed and developing countries (and, to a smaller extent, among developing countries) (Easson 2000). This resembles the spread and diffusion of BITs around the world (Fitzgerald 2002; Neumayer and Spess 2005). By the end of the 1960s there were 322 treaties, which rose to 674 by the end of the 1970s and to 1143 by the end of the 1980s. The number of DTTs worldwide grew rapidly in the 1990s and by 2002 there would be 2,255 DTTs worldwide (UNCTAD 2003). In 2002, China topped the list of developing countries, having concluded 21 DTTs with OECD countries, followed by Czech and Slovak Republics, India, Poland and South Korea with 20 treaties each, Hungary and Romania (19), Russia (18), Bulgaria, Indonesia, Malaysia, Mexico, Philippines, South Africa and Thailand (17), Argentina, Latvia and Pakistan (16), Brazil, Estonia, Lithuania, Morocco and Tunisia (15). Most of these are major hosts of FDI. However, in the middle range are also countries like Zambia (12), Bangladesh (10), Barbados, Côte d'Ivoire and Zimbabwe (8) that are not particularly known as major recipients of FDI inflows. At the bottom end are a great many countries that have concluded either zero or few DTTs.

## 3. The typical contents of BITs and DTTs

The basic provisions of a bilateral investment treaty (BIT) typically guarantee certain standards of treatment for the foreign investor (see Dolzer and Stevens 1995; UNCTAD 1998). By entering into a BIT, signatories agree to grant certain relative standards treatment such as national treatment (foreign investors may not be treated any worse than national investors, but may be treated better and, in fact, often are) and most-favored nation treatment (privileges granted to one foreign investor must be granted to all foreign investors). They also agree to guarantee certain absolute standards of treatment such as fair and equitable treatment for foreign investors in accordance with international standards after the investment has taken place. BITs typically ban discriminatory treatment against foreign investors and include guarantees of compensation for expropriated property or funds, and free transfer and repatriation of capital and profits. Further, the BIT parties agree to submit to binding dispute settlement should a dispute concerning these provisions arise

(UNCTAD 1998). Ostensibly, these provisions should secure some of the basic requirements for credible protection of property and contract rights that foreign investors look for in host countries. They should also protect foreign investors against political and other risks highly prevalent in many developing countries. Far from being neutral, foreign investors are often granted higher security and better treatment than domestic investors (Vandevelde 1998).

The basic provisions of BITs are all direct answers to the fundamental "hold-up" or "dynamic inconsistency" problem that faces developing nations attempting to attract FDI. The dynamic inconsistency problem arises from the fact that although host countries have an incentive to promise fair and equitable treatment beforehand in order to attract foreign investment, once that investment is established and investors have sunk significant costs the host country's incentive is to exploit or even expropriate the assets of foreign investors. Even those host countries that are willing to forego taking advantage in these circumstances will find it very difficult to credibly commit to their position. Many developing countries have adopted domestic legal changes over the last decade or so with a view toward encouraging a greater FDI inflow (UNCTAD 2004). However, these domestic legal rules cannot substitute for the commitment device offered by entering into a legally binding bilateral treaty. BITs, and their binding investor-to-state dispute settlement provision in particular, are meant to overcome the dilemma facing host countries who are willing to denounce exploiting foreign investors after the investment has already been undertaken. Interestingly, at the same time as BITs flourished in the 1980s and 1990s, outright expropriations of foreign investors, which were common during the 1960s and 1970s, practically ceased to take place (Minor 1994).

The extent of interference with domestic regulatory sovereignty developing countries succumb to in signing BITs is enormous. In fact, virtually any public policy regulation can potentially be challenged through the dispute settlement mechanism as long as it affects foreign investors. Often, foreign investors need not have exhausted domestic legal remedies and can thus bypass or avoid national legal systems, reaching straight for international arbitration, where they can freely choose one of the three panelists, their consensus is needed for one other panelist and where they can expect that the rules laid out in the BITs are fully applied (Peterson 2004). This contrasts with domestic courts, where investors have no say on the composition of judges and where domestic rules might trump BIT provisions. BITs have been criticized for not conforming to a truly liberal economic model by failing to ban distorting government policies such as protective tariffs or tax incentives for foreign investors (Vandevelde 2000). However, even critics such as Vandevelde (2000, p. 499) admit that 'BITs seriously restrict the ability of host states to regulate foreign investment'. In concluding BITs, developing countries are therefore 'trading sovereignty for credibility' (Elkins, Guzman and Simmons 2004, p. 4).

By signing DTTs, developing countries provide foreign investors with security and stability as regards the issue of taxation in addition to the relief from double taxation. There are two model treaties for DTTs available, which are regularly updated and on which treaty partners can base their treaty if they wish to do so: one from the OECD, the other one from the United Nations. Not surprisingly, the OECD model treaty clearly favours residence taxation, which benefits developed countries since it is mainly developed country investors who invest in developing countries, not the other way around and residence taxation favours countries with net positive foreign asset positions. The UN model treaty, on the other hand, provides more room for source-based taxation, which is more beneficial to developing countries for the same reason. Critics argue, however, that the UN model treaty is not sufficiently different from the OECD model treaty and is still biased against developing country interests (Figueroa 1992). Also, the vast majority of DTTs are based more on the OECD model (Arnold, Sasseville and Zolt 2002).

The reduction in tax revenue following limits on source-based taxation clearly represents a cost to developing countries. This is the more so as developing countries typically have very unequal income distributions that governments stripped of financial resources will find difficult to address via transfer payments (Fitzgerald 2002). Dagan (1999: 939) goes as far as arguing that DTTs serve the 'cynical goal' of 'redistributing tax revenues from poorer to the richer signatory countries' (similarly Figueroa 1992).

## 4. Review of competing studies

It is most astonishing that despite the rising number of BITs, there are only three other serious studies examining the effect of such treaties on the location of FDI.[23] The first study has been undertaken by Hallward-Driemeier (2003), looking at the bilateral flow of FDI from 20 OECD countries to 31 developing countries over the period 1980 to 2000. Her research design is dyadic, consisting of up to 537 country pairs. Using fixed effects estimations, she finds that the existence of a BIT between two countries does not increase the flow of FDI from the developed to the developing signatory country. This is true whether the dependent variable is measured as absolute flows, flows divided by host country's GDP or the share of the source countries' FDI outflow. Interacting the BIT variable with various measures of institutional quality, she finds a positive coefficient of the interaction term that is often statistically significant. This would suggest that, contrary to theoretical expectations, BITs are complements to good institutional quality and therefore do not perform their original function, namely to provide guarantees to foreign investors in

23) A fourth study is provided by UNCTAD (1998). However, it is based on a purely cross-sectional stepwise (!) regression analysis with an unspecified number of observations from 1995. Not surprisingly, such 'garbage can' modelling leads to inconclusive results.

the absence of good domestic institutional quality.

In the second study, Tobin and Rose-Ackerman (2005) analyze the impact of BITs on general non-dyadic FDI inflows, also in a panel from 1980 to 2000, but with data averaged over five-year periods, covering 63 countries. Whilst both studies draw upon data provided by International Country Risk Guide (ICRG), Hallward-Driemeier (2003) uses individual components of institutional quality, whereas Tobin and Rose-Ackerman (2005) use the aggregate political risk measure, which includes many more components than institutional quality, including some that are not directly related to political risk (such as, among others, religious and ethnic tensions, armed conflict and socio-economic conditions such as unemployment and poverty). In a fixed effects model, Tobin and Rose-Ackerman find that a higher number of BITs either in total or signed with a high income country *lowers* the FDI a country receives as a share of global FDI flows at high levels of risk and raises the FDI only at low levels of risk. In an additional dyadic analysis of 54 countries, they fail to find any statistically significant effect of BITs signed with the US on FDI flows from the US to developing countries, either conditionally on the level of political risk or unconditionally.

The third study provides three cross-sectional analyses of FDI inflows to up to 99 developing countries in the years 1998, 1999 and 2000, respectively, as well as a fixed effects estimation of the bilateral flow of FDI from the US to 31 developing countries over the period 1991 to 2000. Salacuse and Sullivan (2005) find the signature of a BIT with the US to be associated with higher FDI inflows in both types of estimations, whereas the number of BITs with other OECD countries is always statistically insignificant.

The three studies suffer from a number of shortcomings that we try to improve on in our own study. Halward-Driemeier's (2003) model presumes that a BIT will only have an effect on the flow of FDI from one developed country, namely the signatory, to the developing country. However, this presumption neglects the signaling effect of BITs (Elkins, Guzman and Simmons 2004, p. 21). As pointed out in the preceding section, in concluding a BIT, the developing country commits to protect foreign investments, explicitly only the FDI from the signatory developed country, but implicitly it also signals its willingness to protect all foreign investment. There are therefore likely to be positive spill-over effects from signing a BIT. Halward-Driemeier's modeling cannot capture the potential of BITs to attract more FDI from other developed non-signatory countries as well, and consequently may underestimate the effect that signing a BIT has on the inward flow of FDI. In addition to not capturing this potentially important spill-over effect, the dyadic design also has another major disadvantage. Data on bilateral FDI flows are very sparse, and consequently the size of her sample is significantly limited by this choice. A sample of 31 developing countries is everything but representative. Similar arguments apply to Salacuse and Sullivan's (2005) fixed effects analysis.[24] Our own study draws from a much larger and more representative sample.

Where Tobin and Rose-Ackerman (2005) do not use a dyadic research design, the paucity of bilateral FDI flow data does not impose a binding constraint on sample size. Nevertheless, for no clear reason their sample consists of only 63 countries. In comparison, our own sample is both deeper and wider. It covers the period 1970, the first year for which UNCTAD provides FDI data, to 2001, the last year for which we have available data. It also covers up to 119 developing countries, which amounts to a much more representative sample. The countries included in our sample are listed in appendix 1. Salacuse and Sullivan's (2005) cross-sectional analysis also has the advantage of a large sample size. However, by definition this type of analysis cannot control for country-specific unobserved heterogeneity, which is likely to be important, nor does it exploit the full information available from looking at FDI flows over a longer time period.

As concerns DTTs, Blonigen and Davies (2002) in an analysis of bilateral FDI flows and stocks among OECD countries over the period 1982 to 1992 find that the existence of DTTs is associated with larger bilateral FDI flows and stocks in ordinary least squares (OLS) estimation. However, when older DTTs, which have often been concluded many years *before* the start of the study period, are distinguished from newer DTTs, which were concluded *during* the period of study, then it appears that these newer treaties have no positive effect on FDI in OLS estimation, and possibly even a negative effect in fixed-effects estimation. Similarly, Blonigen and Davies (2004) in an analysis of U.S. inbound and outbound FDI over the period 1980 to 1999 find that treaties concluded during this period had no statistically significant effect at best and a negative effect at worst on inbound and outbound FDI stocks. Davies (2004) confirms the non-significant and negative findings of both studies and, additionally, finds non-significant results if looking explicitly at treaty renegotiations. Egger et al. (2004) also find a negative effect of newly implemented DTTs in a differences-in-differences analysis of two years prior and two years after treaty conclusion using bilateral FDI data over the period 1985 to 2000. While analysing merger and acquisition (Mand A) deals rather than FDI over the period 1990 to 1999, Di Giovanni (2005) comes to the interesting finding that the existence of a DTT is associated with higher cross-border Mand A flows.

The major problem with existing studies of DTTs is twofold: First, where the sample only contains OECD countries as in Blonigen and Davies (2002), results might not tell us anything valid for developing countries as FDI allocation decisions are likely to be based on drastically different motivations in both groups of countries (Blonigen and Wang 2004). For the same reason the simultaneous presence of both OECD and developing countries in the sample, as in Blonigen and Davies (2004) and Egger et al. (2004), is problematic as well.

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24) Their study also suffers from the absence of year-specific time dummies controlling for aggregate annual changes in US FDI outflows, which could mean that the results are spurious.

Second, the use of bilateral FDI data, which is otherwise a strength, necessarily leads to a sample that is very restrictive and non-representative due to lack of data. This would not matter so much if the sample of countries, for which data are available, was a random one. This is not the case, however, since bilateral FDI data exist for practically all OECD countries, but for developing countries by and large only if their per capita income is relatively high or their population size is large. This excludes the very set of poor and small to medium-sized developing countries, for which the conclusion of a DTT can be an important instrument to woo foreign investors.

## 5. Description of Research Design

In the study, as our main measure of FDI attractiveness, we use the absolute amount of FDI going to a developing country, converted to constant US$ of 1996 with the help of the US GDP deflator (data from UNCTAD 2005). We use absolute FDI flows because if one were to use FDI inflow as a percentage of host country's GDP instead, the measure would capture changes in the relative importance of foreign investment to the host country, but not changes in inflows directly. Quite possibly, the worldwide increase in the rate of the conclusion of BITs and DTTs is partly responsible for the increase in overall FDI going to developing countries. However, there is always the danger that one finds a statistically significant relationship between two upward trending variables that is spurious. We deal with this potential problem in two ways. First, we employ year dummies to account for any year-to-year variation in total FDI flows unaccounted for by our explanatory variables, which should mitigate potential spuriousness of any significant results. Second, as an alternate dependent variable to the absolute amount of FDI we use the FDI inflow a country receives relative to the sum of FDI going to developing countries. Since this variable is not trending over time no year-specific time dummies are included in these sets of estimations. FDI inflow as a share of developing country FDI as the dependent variable captures the relative attractiveness of developing countries as hosts for FDI and explicitly allows for competition amongst them for a fixed sized cake of FDI to be divided. Ideally, one would like to disaggregate FDI flows according to economic sectors. Unfortunately, no comprehensive information is available for a large panel of countries.

We take the natural log of the dependent variable to reduce the skewness of its distribution. This increases the model fit substantially. To do so, we need to recode a small number of negative FDI flows. Negative FDI flows essentially imply 'instances of reverse investment or disinvestment' (UNCTAD 2001, p. 292). In our analysis we set negative FDI flows equal to positive FDI flows of one US$. If instead one were to discard all negative flows then results are hardly affected.

Our main explanatory variables are the cumulative number of BITs and DTTs a developing country has signed with OECD countries, weighted by the share of outward FDI flow the OECD country accounts for relative to total world outward FDI flow. Data are taken from UNCTAD (2005) with information on DTTs for several OECD countries provided directly by UNCTAD's International Arrangements Section. As mentioned above, the weighting is to account for differences in the size of potential FDI, for which a developing country has double taxation provisions in place. We exclude BITs and DTTs signed between developing countries since FDI flows between developing countries are rare.

Our control variables include the natural log of per capita income, the log of total population size and the economic growth rate as indicators of market size and market potential (data from World Bank 2003a), a dummy variable indicating whether a country is a member of the World Trade Organization as well as a variable counting the number of bilateral trade agreements a developing country has concluded with the US, the European Community/European Union or Japan, based on information contained in WTO (2004) and EU (2004). The inflation rate is a proxy variable for macroeconomic stability. Data are taken from World Bank (2003a). We employ a measure of natural resource intensity to control for the fact that, all other things equal, large natural resources are a major attractor to foreign investors. Our measure is equal to the sum of rents from mineral resource and fossil fuel energy depletion divided by gross national income, as reported in World Bank (2003b). There is a long tradition of studies analysing the effect of political stability and institutional quality on FDI inflows (see, for example, Schneider and Frey 1985; Alesina and Perotti 1996; Wheeler and Mody 2000; Globerman and Shapiro 2002). We use the political constraints (POLCON) index developed by Henisz (2000).

We estimate both random-effects and fixed-effects models, in which case we can employ robust standard errors. We suspect that there are factors making a country attractive to foreign investors that are not captured by our explanatory variables and that are (approximately) time-invariant, such as colonial history, culture, language, climate, geographical distance to the centers of the Western developed world, legal restrictions on inward FDI etc. To mitigate potential reverse causality problems, we lag all explanatory variables by one year.

## 6. Summary of Results

For detailed reporting of results, the interested reader is referred to Neumayer and Spess (2005) and Neumayer (2005). In sum, the results show the following:

1. Developing countries that sign more BITs receive more FDI.
2. There exists weak evidence that BITs function as substitutes for poor domestic institutional quality.
3. Developing countries that sign more DTTs receive more FDI.

These results are robust to a number of model modifications. For example, lagging the explanatory variables by one year mitigates potential simultaneity bias, but this lag length is somewhat arbitrary. The positive impact of the BIT and DTT variable on FDI inflows is maintained if the lag length is two, three or four years instead. Next, we checked whether our main results are due to the presence of problematic countries. In particular, we excluded all Eastern European and former Soviet Union countries from the sample. However, results hardly change. We also excluded countries with a population size of less than one million from the sample to eliminate the influence of very small countries, but the results were hardly affected. Finally, results are also robust to excluding outliers based on influential outliers as defined in Belsley, Kuh and Welsch (1980).

In further sensitivity analysis, we also included a measure of trade openness, which has a theoretically ambiguous effect on FDI (Taylor 2000). On one hand, countries that are more open to trade can be more attractive host countries if the main purpose of foreign investment is to export the goods or services produced. On the other hand, high trade barriers could make it in a company's best interest to locate production within the host country in order to circumvent the import barriers. Following Noorbakhsh, Paloni and Youssef (2001), we also included the secondary enrolment ratio to account for human capital as a determinant of FDI. Results are again robust.

## 7. Conclusion

Developing countries that sign more BITs and DTTs with developed countries receive more FDI inflows. The effect is robust to various sample sizes, model specifications and whether or not FDI flows are normalized by the total flow of FDI going to developing countries. The message to developing countries therefore is that succumbing to the obligations of BITs and to the restrictions on their authority to tax corporate income from foreign investors typically contained in DTTs does have the desired payoff of higher FDI inflows.

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# Foreign Direct Investment and Economic Growth in East Asia

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## I. Introduction

East Asia achieved remarkable economic growth until it was suddenly struck by the economic crisis in the late 1990s. Although East Asia experienced devastating setback from the crisis, many East Asian economies quickly recovered to achieve reasonable economic growth. Rapid economic growth in the pre-crisis period and quick recovery in the post-crisis period by East Asian economies are attributable to various factors such as sound macroeconomic management, export-oriented policies, availability of low-wage labor and others. Among these factors the role of foreign direct investment (FDI) has to be emphasized.

FDI contributed significantly to the rapid economic growth of East Asia from the mid-1980s until the economic crisis. FDI brought to FDI recipient economies not only financial resources for fixed investment but also technologies and managerial know-how, which played crucial roles in promoting economic growth. In the post crisis period FDI played an important role in keeping East Asian economies from slipping away and recovering from the crisis. Although bank loans and portfolio investments in East Asia declined sharply during the crisis period, FDI flows were resilient. Foreign firms operating in East Asia expanded exports by taking advantage of favorable export environment, which was brought about by sharp depreciation of East Asian currencies.

In light of the importance of FDI in promoting economic growth, this paper attempts to achieve two objectives. One is to examine the patterns of FDI in East Asia and the other is to discern the impacts of FDI environment in the host economies on FDI inflows. Such analysis would provide useful information for the prospective FDI host countries, which are eager to attract FDI to promote FDI.

The remainder of the paper is composed as follows. Section II briefly reviews the studies that examined the impacts of FDI inflows on economic growth to provide the reasons for undertaking a study on FDI inflows. Section III examines the recent patterns of

FDI inflows in East Asia. Section IV discusses various institutional arrangements concerning FDI and it also analyzes the FDI regimes of selected East Asian countries. Section V reviews the determinants of FDI inflows and section VI presents some concluding remarks.

## II. Foreign Direct Investment and Economic Growth

In recent years FDI has become an important factor for the promotion of economic growth of the FDI recipient (or host) countries. The contributions of FDI to economic growth of its recipient have been realized in various forms. FDI has brought not only financial resources for fixed investment but also technologies and managerial know-how, which play crucial roles in promoting economic growth of the recipient economies. Furthermore, FDI enabled the recipient economies to utilize various networks such as sales, procurement, and information networks of foreign firms, to improve efficiency in production and marketing.

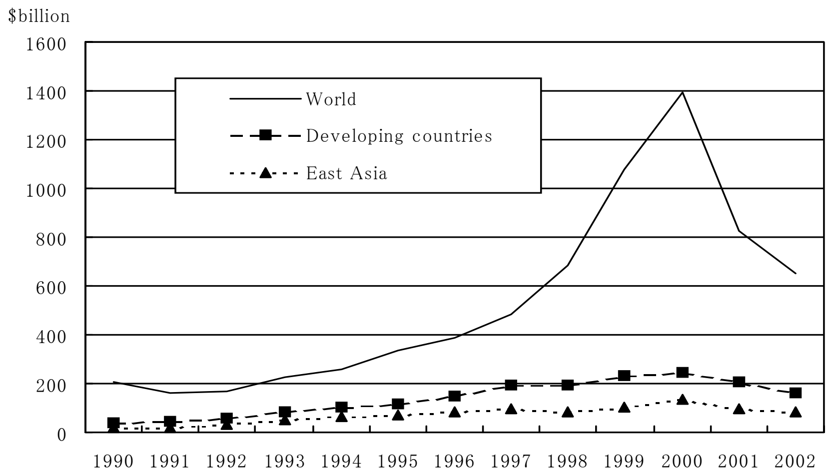
Several studies have confirmed the positive contribution of FDI on economic growth. Examining economic growth of 69 developing countries for 1970-89, Borensztein, de Gregorio, and Lee (1998) find in their regression analysis that FDI has marginally positive impact on economic growth, but it has significantly positive impact when FDI is interacted with educational levels of host countries. Their finding may be interpreted to mean that education becomes more effective when it is associated with foreign knowledge. United Nations (1999) obtained similar findings by examining economic growth of 60-plus countries for 1971-1995 period. Kawai and Urata (2001) found that FDI inflows had significantly positive impacts on economic growth by analyzing the data for 133 countries for 1970-1997. Among the countries in different stages of economic development, they found that FDI inflows had particularly strong positive impacts on economic growth for low-income countries. Their finding appears to indicate that low-income countries without much resource can benefit significantly by attracting financial, technical and other types of resources needed for economic development through FDI inflows.

## III. FDI Inflows in East Asia in Recent Years

FDI inflows in East Asian developing economies experienced an increase in the 1990s and a decline in the early 2000s, although the rate of change is significantly smaller when compared to that experienced by the economies in other regions. Specifically, annual FDI inflows to East Asian developing economies increased sharply from approximately $20-30 billion in the early 1990s to reach $136 billion in 2000, before a decline to $93 billion in 2001 and $84 billion in 2002.

Wide variations can be observed for FDI inflows among East Asian developing economies. Dividing East Asian developing economies into several groups, one finds that China experienced a steady increase in its FDI inflows from the early 1990s to 2002 (Figure 1). Contrasting to the experience of China, ASEAN5 (here includes Indonesia, Malaysia, Philippines, Thailand, and Vietnam) saw a steady increase in FDI inflows until the outbreak of the currency and financial crisis in 1997, which was followed by a dramatic decline in the following years. As a result of these contrasting patterns, China surpassed ASEAN5 in early 1990s and widened the gap notably since then. Indeed, in 2001 FDI inflows to China were more than ten times as large as that for ASEAN5. NIEs4 (consisting of Hong Kong, Korea, Singapore and Taiwan) experienced a steady increase from the early 1990s to 1998 before starting to show a dramatic increase in 1999 and 2000. After experiencing a sharp increase, NIEs4 saw a precipitous decline in FDI in 2001 and 2002.

**Figure 1. FDI Inflows to East Asia**



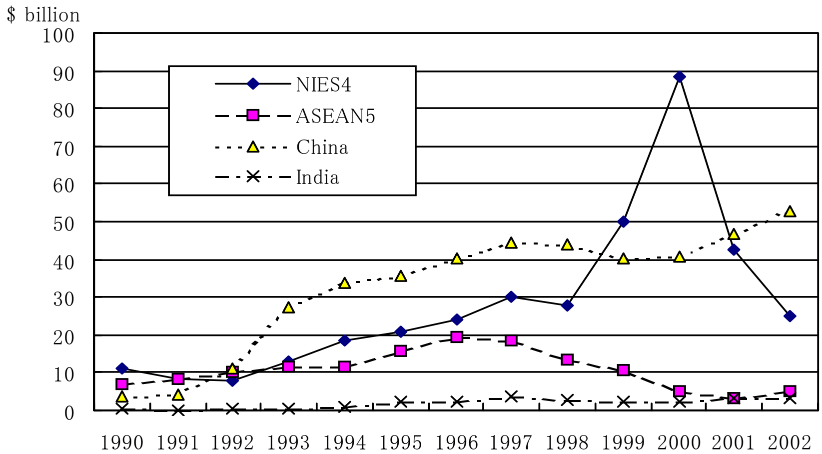

As noted above, among East Asian developing economies, China has attracted FDI successfully since the early 1990s. Indeed, China has been the largest recipient of FDI among developing economies since the early 1990s, and it became the world largest recipient in 2002. Some of the factors that make China attractive host to FDI include the presence of large market and availability of low-wage workers. In addition, trade and FDI liberalization, and especially its accession to the WTO contributed substantially to recent increase in FDI inflows.

Among ASEAN5 countries, Thailand, Malaysia, and Indonesia recorded notable increase in FDI inflows before the crisis. The crisis changed the situation dramatically, as FDI inflows to Malaysia and Indonesia dropped significantly after the crisis. FDI inflows to Indonesia turned negative, that is disinvestment, in 1998 and disinvestment has continued through 2002. Political instability resulting from the changes in political regimes appears to be an important factor behind the decline in FDI for Indonesia. In contrast to the case for

Indonesia, FDI inflows to Thailand increased after the crisis and remained at relatively high levels through 2001. Thai government promoted FDI inflows by liberalizing FDI policies, in order to deal with the crisis, resulting in large FDI inflows. In relative terms FDI inflows to the Philippines and Vietnam remained constant through the period under study.

Among the Asian NIES4, Hong Kong exhibited substantial growth in FDI inflows in 1999 and 2000. Although FDI inflows to Hong Kong declined sharply in 2001, the level of FDI inflows to Hong Kong was still substantially larger than the levels achieved by other NIEs. Having noted large FDI inflows to Hong Kong, it is important to recognize the possibility of overestimation of FDI inflows to Hong Kong. This is because a substantial portion of FDI inflows to Hong Kong has been reinvested in China. It should also be noted that a large increase in 2000 was due to a single large investment in the telecommunication sector worth $23 billion. Singapore kept pace with Hong Kong until the outbreak of the crisis. Although Singapore experienced a decline in FDI inflows in the aftermath of the crisis, it was successful in regaining attractiveness quickly. Korea recorded a substantial increase after the crisis in 1998. This increase was largely due to drastic liberalization of FDI policies, which Korean government adopted to deal with the negative impacts of the crisis. Similar to the pattern observed for Korea, FDI inflows in Taiwan increased after the crisis, although the magnitude of the increase was substantially smaller compared to the case for Korea.

**Figure 2. FDI Inflows to Developing Asia**




Expansion of FDI inflows in East Asian developing economies resulted in the increased importance of MNCs in economic activities for these economies. Such development can be confirmed by several indicators. Table 1 shows two types of information, the importance of MNCs in employment, sales, and value added, and the proportion of FDI inflows to domestic capital formation for selected East Asian economies. An examination of the first set of information reveals that MNCs' importance varies widely among the economies.

MNCs have a sizeable presence in Singapore, Malaysia, and Hong Kong, as MNCs's shares in employment and/or sales for the manufacturing sector in these economies amount to as high as 40-80 percent. Although significant, MNCs' presence is smaller for Taiwan, China,

**Table 1. Importance of Foreign MNCs in East Asian Economy**

(%)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Employment (manufacturing) | | | | | | | | | | | |
| Hong Kong | 12.9 | 13.4 | 13.2 | 14.2 | 16.9 | 19.3 | 20.3 | 22.5 | -- | -- | -- |
| Indonesia | -- | -- | 3.3 | -- | -- | -- | 4.7 | -- | -- | -- | -- |
| Malaysia | -- | -- | 43.2 | 45.6 | 45.9 | 43.2 | 43.7 | 38.5 | -- | -- | -- |
| Singapore | -- | -- | 59.7 | 58.1 | 56.8 | 55.1 | 55.1 | 54.8 | 53.4 | 52.3 | 49.9 |
| Taiwan | -- | -- | 12.8 | 11.9 | 9.9 | 10.6 | -- | -- | -- | -- | -- |
| Viet Nam | -- | -- | -- | -- | -- | -- | 22.6 | -- | -- | -- | -- |
| Sales (manufacturing) | | | | | | | | | | | |
| China | 2.3 | 5.3 | 7.1 | 9.1 | 11.3 | 14.3 | 15.1 | 18.6 | 24.3 | 27.7 | 31.3 |
| Hong Kong | 22.6 | 26.0 | 27.0 | 30.8 | 35.7 | 43.5 | 44.6 | 44.8 | -- | -- | -- |
| India | 5.4 | 5.5 | -- | 6.1 | 5.5 | 3.1 | -- | -- | -- | -- | -- |
| Malaysia | 44.1 | 45.4 | 47.6 | 48.6 | 52.6 | 50.1 | -- | -- | -- | -- | -- |
| Singapore | 76.9 | 75.4 | 74.7 | 74.8 | 75.1 | 75.6 | 75.9 | 75.8 | 76.0 | 81.1 | -- |
| Taiwan | 17.8 | 19.2 | 20.9 | 18.7 | 21.5 | -- | -- | -- | -- | -- | -- |
| Value added (whole economy) | | | | | | | | | | | |
| China | -- | -- | -- | -- | -- | 4.4 | 4.2 | 4.8 | -- | -- | -- |
| Malaysia | 17.5 | 18.6 | 20.1 | 20.6 | 23.1 | 23.8 | -- | -- | -- | -- | -- |
| Viet Nam | -- | -- | -- | -- | -- | 11.3 | 11.6 | 12.5 | -- | -- | -- |
| Capital formation (proportion of FDI inflows in gross domestic capital formation, whole economy) | | | | | | | | | | | |
| Cambodia | -- | -- | 17.0 | 18.8 | 15.5 | 23.5 | 36.1 | 28.7 | 56.4 | 48.2 | 31.1 |
| China | 3.5 | 3.9 | 7.4 | 12.2 | 17.3 | 14.8 | 14.3 | 14.6 | 13.1 | 11.3 | 10.4 |
| Hong Kong | 16.3 | 4.4 | 13.8 | 21.5 | 19.8 | 14.4 | 21.4 | 19.5 | 29.4 | 58.6 | 138.9 |
| Macao | 0.1 | 1.0 | -1.2 | -0.2 | 0.2 | 0.1 | 0.4 | 0.2 | -1.5 | 0.9 | -0.1 |
| Taiwan | 3.7 | 3.2 | 1.8 | 1.6 | 2.3 | 2.4 | 3.0 | 3.4 | 0.4 | 4.4 | 6.8 |
| India | 0.3 | 0.1 | 0.4 | 0.9 | 1.4 | 2.4 | 2.9 | 4.0 | 2.9 | 2.2 | 2.3 |
| Indonesia | 3.4 | 4.1 | 4.7 | 4.8 | 4.3 | 7.6 | 9.2 | 7.7 | -1.5 | -9.7 | -14.3 |
| Korea | 0.8 | 1.0 | 0.6 | 0.5 | 0.6 | 1.0 | 1.2 | 1.7 | 5.7 | 8.3 | 7.1 |
| Lao PDR | -- | -- | -- | -- | -- | 19.3 | 23.6 | 18.2 | 14.4 | 15.7 | 9.8 |
| Malaysia | 18.0 | 22.6 | 23.7 | 22.1 | 15.3 | 15.0 | 17.0 | 14.7 | 14.0 | 22.2 | 16.5 |
| Myanmar | 4.6 | 5.4 | 3.4 | 1.7 | 1.4 | 2.2 | 2.9 | 3.7 | 2.1 | 0.8 | 0.7 |
| Philippines | 5.4 | 6.1 | 7.0 | 9.6 | 10.5 | 9.6 | 8.3 | 6.3 | 12.5 | 11.9 | 9.7 |
| Singapore | 46.8 | 33.6 | 12.5 | 23.1 | 36.1 | 40.8 | 26.6 | 37.0 | 24.7 | 47.6 | 45.6 |
| Thailand | 7.5 | 5.0 | 4.9 | 3.7 | 2.4 | 3.0 | 3.1 | 7.6 | 29.9 | 23.8 | 12.4 |
| Viet Nam | 21.2 | 35.9 | 28.0 | 32.2 | 49.3 | 34.7 | 29.5 | 37.3 | 23.9 | 20.1 | 15.0 |

Note: The figures under employment, sales, and value added indicate the shares of overseas subsidiaries of foreign MNCs in respective domestic economic activities. The figures under capital formaiton indicate the proportion of FDI inflows to domestic capital formation.
Source: UN. World Investment Report 2002, and UNCTAD website.

and Viet Nam, when compared to the cases for Singapore, Malaysia, and Hong Kong. MNCs' presence in Indonesia and India is very limited.

Turning to the statistics on the proportion of FDI inflows to domestic capital formation, one finds that for many countries the proportion increased in the mid-1990s, reflecting the increase in FDI inflows. The economies that have high FDI inflow-domestic capital formation ratios around 30-50 percent include Singapore and Hong Kong. Those with the ratios registering 10-20 percent are China, Malaysia, Thailand, and Vietnam, while Taiwan, Indonesia, Korea, and India show very low figures with less than 10 percent.

The differences in the patterns of FDI inflows and those in the importance of FDI inflows in economic activities among East Asian economies are attributable to various factors including economic conditions, policy environment, and future economic outlook. In light of these observations, we examine FDI policy environment for these economies in section IV. Before examining FDI policy environment in East Asian developing economies, we briefly examine the patterns of FDI outflows from East Asian economies and the United States, a major investor in East Asia.

## IV. FDI Policy Environment in East Asia[25)]

A number of factors influence FDI flows. They include economic, political, and institutional environments in recipient and investing countries. We will analyze the importance of these factors by using statistical analysis in a later section, and in this section we examine the FDI policy environment in East Asian developing economies, which certainly have important influence on FDI flows. Recognizing the importance of FDI inflows in promoting economic growth and responding to requests and pressure from MNCs for a freer FDI environment, many countries have established various institutional frameworks regarding FDI, including multilateral, regional and bilateral frameworks, which would provide favorable environment for FDI.

### *IV.1. GATT/WTO Trade Related Investment Measures (TRIMs)*

The Uruguay Round of the General Agreement on Tariffs and Trade (GATT) reached an agreement on investment rules, which was the first time in the history of GATT multilateral negotiations that the members took up the issue of FDI. One of the contentious issues was the coverage of the rule. After a series of intense talks, an agreement was reached to prohibit trade related investment measures (TRIMs) that violate the GATT rules. Specifically, it was agreed to prohibit TRIMs that violate the two following GATT rules: national treatment applied to imported products (Article III) and general elimination of quantitative restrictions on imports (Article XI). The specific TRIMs that violate the national

25) This section draws on Urata (1998)

treatment rule include the local-content requirement and trade balancing requirements. Trade balancing requires that imports of foreign firms do not exceed their exports. TRIMs that violate the general elimination of quantitative restrictions are trade balancing requirements, restrictions on foreign exchange transactions, and local sales requirements. Local sales requirements force foreign firms to limit their exports.

Although the rules regarding FDI that were established in the Uruguay Round are limited to issues of foreign trade and TRIMs, it is worth noting that the Uruguay Round was the first trade negotiations under which measures related to FDI were taken up. However, no agreements were reached on other restrictive measures related to FDI, such as restrictions on the extent of equity participation and requirements for technology transfer and exports. Because of this, there are still many government interventions to be removed before a true free FDI environment will be established. It is worth noting in the General Agreement on Trade in Services (GATS) that an agreement was reached that ensures the right of establishment in service trade, a significant step toward assuring the right of establishment for firms undertaking FDI.

### *IV.2. APEC's Non-Binding Investment Principle (NBIP)*

Achieving free trade and investment in the APEC region has been one of APEC's central objectives. The APEC members have liberalized their trade and FDI policies unilaterally in recent years, but many areas remain to be liberalized in a number of APEC member economies. Recognition of these issues led to the agreement on Non-Binding Investment Principles (NBIP) in November 1994. It should be noted that an increasing number of developing APEC members that have been recipients of FDI are now becoming active investors, contributing to the establishment of the NBIP

The expansion of FDI has been recognized as an important element for the promotion of economic growth in the Asia-Pacific region by APEC members since the inception of APEC in 1989. Since 1989, the framework for the liberalization of FDI has been shaped gradually.

In Indonesia in 1994, APEC leaders issued the Bogor Declaration, declaring their intention to achieve free and open trade and investment in the APEC region. The declaration established a target date for reaching that goal: no later than 2010 for the industrialized members and no later than 2020 for the developing members. Prior to the Bogor Declaration at the APEC meeting in Jakarta, the ministers endorsed the Non-Binding Investment Principles (NBIP).

The NBIP consists of four sections: principles that govern international relations, codes of conduct for government, codes of conduct for investors, and a system for dispute settlement. The three general principles of international relations are transparency, national treatment, and nondiscrimination. The codes of conduct for government stipulate the use of specific policies related to FDI: investment incentives, performance requirements, expropriation and compensation, transfer of funds, settlement of investment disputes, entry and stay of expatriates, tax measures, and capital movements. These codes of conduct are meant to discourage the use of investment- distorting policies, but the diversity of APEC members has made it difficult to implement these codes uniformly.

Despite the presence of divergent views, codes of conduct for investors were included in the NBIP as they were considered to balance the set of principles. These codes of conduct state that foreign investors should abide by the host country's laws, regulations, administrative guidelines, and policies, just as domestic investors do. A dispute settlement provision is included in the NBIP but lacks a detailed mechanism or procedure. It suggests only that disputes will be settled promptly through consultations and negotiations between parties through arbitration procedures acceptable to all. Finally, it is stated that the NBIP must not violate existing bilateral or multilateral treaties, including the agreement on TRIMs under the WTO.

After agreeing on the NBIP in order to establish an open investment regime in the APEC region, APEC has not achieved much in FDI liberalization, indicating that the NBIP has not been effective. One of the criticisms concerning a lack of effectiveness of NBIP is its non-binding nature. Some have argued to make it binding, but the opposition has argued that binding principles would be inconsistent with fundamental APEC principle of voluntarism. Indeed, APEC is at the critical juncture in search for its reason for existence as an organization for the promotion of FDI and trade liberalization.

### *IV.3. Bilateral Investment Treaties and Free Trade Agreements*

We saw the establishment of multilateral and regional frameworks concerning liberalization of FDI policies, which would contribute to the promotion of FDI flows in East Asia and other regions. Despite the presence of these frameworks, bilateral and plurilateral investment treaties, some of which are included in free trade agreements, have been increasing.

Bilateral investment treaties (BITs) have been recognized as instruments for the promotion and legal protection of FDI. In addition to determining the scope of application of the treaty, that is, the investments and investors covered by it, virtually all BITs cover four substantive areas: admission, treatment, expropriation and the settlement of disputes. Specifically, recent BITs stipulate the rules on the right of establishment, national treatment, prohibition of certain performance requirement, and others. It is worth noting that United Nations indicates that in some cases BITs may put local firms at a competitive disadvantage vis-à-vis their foreign counterparts.

BITs have been increasing rapidly since the early 1990s, as MNCs have become active in undertaking FDI. Indeed, the cumulative number of BITs worldwide increased five-fold in twelve years from 446 in 1990 to 2,181 in 2002. In the past BITs were concluded between developed countries, or between developed and developing countries. However, in recent years BITs have become to be concluded between developing countries, reflecting their recognition of the importance of stable and transparent FDI environment. Similar to the pattern observed in the rest of the world, East Asian developing economies have been active in concluding BITs since the 1990s. Among East Asian developing economies, China has been most active in concluding BITs. As of 2002, China had 107 BITs. Malaysia, Korea, and Indonesia are also quite active as they had 67, 62, and 56 BITs, respectively.

FTA is traditionally a framework for free trade among member countries. However, recent FTAs go beyond free trade, and some have arrangements for free FDI. For example, the NAFTA has agreements on MFN (most-favored-nations) and national treatment for foreign firms, and a mechanism for dispute settlement. Newly enacted Japan-Singapore FTA has also various components toward achieving free FDI including national treatment of foreign companies, protection of investors, abolition of performance requirement.

As to the plurilateral investment arrangement, ASEAN Investment Area (AIA) is one of few such arrangements in East Asia. The framework agreement for AIA was concluded in 1998. The purpose of AIA is to create a competitive investment area within ASEAN with a more liberal and transparent investment environment with an aim of attracting FDI inflows into ASEAN from both ASEAN and non-ASEAN sources. Specifically, the deadline for the opening up and national treatment of all industries, with temporary exclusion lists and sensitive was initially set for 2010 for ASEAN investors and 2020 for non-ASEAN investors. However, ASEAN leaders brought forward the target date for exclusion to 2003 for the original ASEAN-6 and Myanmar, while Vietnam and Laos will, on a best endeavor basis, try to achieve early realization of AIA by no later than 2010.

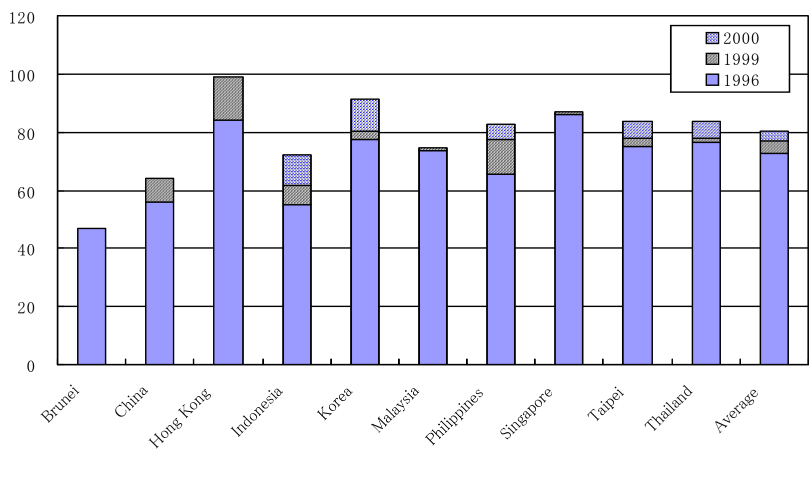
Rapid increase in bilateral and plurilateral investment treaties stems from the dissatisfaction with the multilateral and regional frameworks by many countries. Some benefits of bilateral and plurilateral investment treaties include 'high-level' contents and short negotiating time. These treaties certainly have contributed to the expansion of FDI. However, we should not forget some problems with such treaties. One is inconsistency in the contents of treaties between different treaties, making the FDI environment complex and confusing. Another problem may be that it results in a great many negotiations, thus incurring enormous costs. It has also been suggested that FDI regimes can be liberalized with less difficulty when liberalization is carried out regionally or multilaterally, because the negative effect of FDI liberalization on some groups in the economy is likely to be offset by favorable effects in other areas.

### *IV.4. Foreign Direct Investment Regimes of East Asian Developing Economies*

Many East Asian developing economies liberalized their policies on FDI in recent years mainly because of their recognition of the importance of FDI in promoting economic growth. This observation is supported by our assessment of investment regimes for selected East Asian developing economies based on the information given in the IAPs, which were submitted to APEC. The summary of the assessment is shown in Figures 3 and 4. The assessment is conducted by evaluating the description on the rules on FDI in the following fashion. Eleven categories concerning FDI regimes were selected to evaluate the investment regimes, for which the necessary information is available from the IAPs. Eleven categories are market access, examination procedure, MFN, profit repatriation, work permit, taxation, performance requirement, protection of investors, dispute settlement, investment incentives, and capital exports. These categories are used in the IAPs to discuss FDI regimes.

For each category scoring is conducted on 1-10 scale, with a score of 10 reflecting no restrictions. Score of zero is given when no information is provided in the IAP. This treatment may be justified because a lack of disclosure of the rules is a substantial obstacle to FDI. To obtain the score for all the categories, the right of establishment (market access) is given a weight of 10 while for other categories weight of 1 is given. This treatment reflects the fact that the right of establishment is the most important regulation on inward FDI.

**Figure 3. An Assessment of FDI Regimes in East Asian Economies**

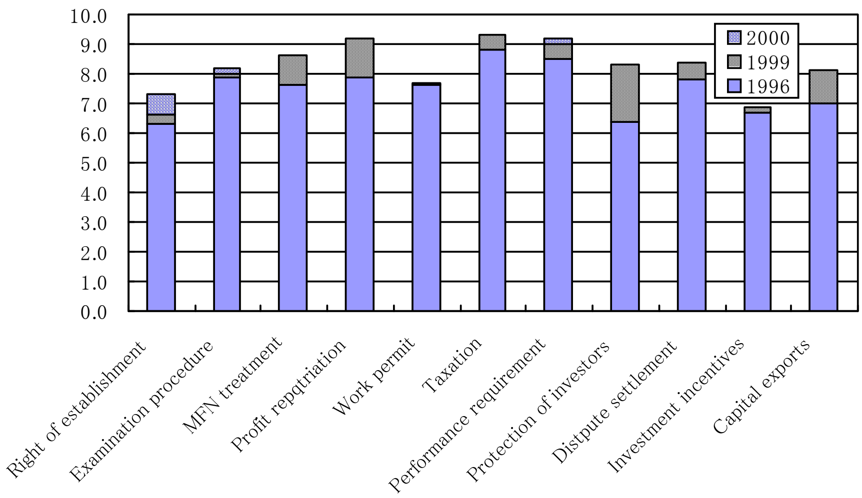



The scores for East Asian developing economies, for which the information is available, are shown in Figure 3, while the average scores for the eleven categories for East Asian developing economies are shown in Figure 4[26]. An examination of the scores in Figure 6 reveals that East Asian developing economies liberalized their FDI regimes during the 1996-2000 period, as the average overall scores increased from 73 in 1996 to 81 in 2000.

[26] The detailed information is given in Japan PECC (2002).

Among the East Asian developing economies Hong Kong is given the highest score at 99 for 2000. The economies with high scores include Korea, Singapore, Taiwan, Thailand, and the Philippines, as each of these economies is given the scores above 80. In contrast, Brunei and China are given low scores. It should be noted, however, China improved its score over the 1996-2000 period. Indonesia and Malaysia are placed in between these two groups concerning the openness of FDI regime. As one would expect, more developed economies exhibit high scores, reflecting open FDI regimes, while less developed economies show relatively low scores, indicating restrictive FDI regimes. It should be emphasized at this point that the assessment is conducted by examining documented FDI regulations, which may be different from actual practice. Indeed, substantial discrepancy will be observed below between what is documented as FDI regulations and actual practices.

**Figure 4. An Assessment of FDI Regimes in East Asian Economies by Category**




An examination of the scores for individual categories in Figure 4 shows that taxation, profit repatriation, performance requirement register high scores in 2000. Low scores are given to investment incentives, right of establishment, and work permit. It should be noted that substantial improvement in the scores was recorded for market access, while the scores for work permit and investment incentives remain low despite some improvement.

One interesting characteristic of the scores for market access and investment incentives is wide variations in the scores among East Asian developing economies under study. As for market access, Brunei and China register very low scores at 4 and 5, respectively, reflecting that the entry by foreign firms is restricted. By contrast, Hong Kong, and Korea have very high scores, indicating that their markets are very open to foreign firms. As to investment incentives, both Korea and Malaysia register low scores of 6, while the score of ten was given to Hong Kong.

Unlike the scores for market access and investment incentives, the scores for work permit do not vary much among the sample economies. This observation reflects the difficulties associated with opening up the labor market, because of the sensitive issue of possible negative impacts of increased foreign personnel on unemployment.

Comparing the scores for the three years, one finds that profit repatriation, and protection of investors achieved substantial improvement. As to the improvement in the scores for different economies, one observes, Hong Kong, Indonesia, Korea, and the Philippines showed remarkable development because their respective scores increased more than 10 points.

## V. The Determinants of FDI Inflows

Several studies have examined the determinants of FDI inflows. United Nations (1998) provides a good survey of the past studies. In addition, it provides a useful framework to investigate the determinants of FDI inflows. According to the suggested framework, the host country determinants of FDI inflows can be grouped into three categories, policy framework for FDI, economic determinants, and business facilitation. Policy framework for FDI includes economic, political and social stability, FDI policy, trade policy among others. Economic determinants are further grouped into three categories depending on the types of FDI motives. For FDI with market seeking motives, market size, market growth, access to regional and global markets, and country-specific consumer preferences are envisaged as important factors, while for FDI with resource/asset-seeking motives, availability of raw materials, low-cost unskilled labor, skilled labor, technological assets, and physical infrastructure are discussed to be important. Finally, for FDI with efficiency-seeking motives, availability of low-cost unskilled labor, intermediate inputs, membership of a regional integration agreement conducive to the establishment of regional corporate networks are considered to be important determinants. As to business facilitation, investment incentives, administrative efficiency, and social amenities such as bilingual schools are argued to play important roles in determining FDI inflows.

In the previous analyses a set of variables representing some of the determinants discussed above were tested to explain FDI inflow values. Typical studies have included nominal GDP, growth in real GDP, GDP per capita, and political stability as explanatory variables. The first three variables capture the elements related to market size and market growth, while political stability is used as a proxy for stability in political as well as institutional environments. The studies generally found the positive and statistically significant coefficients on market size, real GDP growth and political stability, while the estimated coefficients on GDP per capita are mixed. The mixed results on GDP per capita reflect two different meanings of the variable. On the one hand, GDP per capita is a proxy for the purchasing power of the host country population, while it can be a proxy for the wage rate. One would expect a positive impact of GDP per capita on FDI inflow, if the objective of FDI is to expand sales in the host economy, while the impact is likely to be negative if FDI is of efficiency seeking type.

In addition to GDP (ln GDP), real GDP growth (GROWTH), per capita GDP (GDPCAP), and political stability (RISK) measured by political risk, Urata (2005) included five additional variables, inflation (INF, -), exchange rate (EX, ?), openness in trade (TRADE, +), secondary school enrollment ratio (EDU, +) and electricity generation per capita (ELEC, +). to represent availability of educated labor and infrastructure.

The results of the estimation reproduced in Table 2. The results are generally consistent with our expectation. Urata attempted to examine the impacts of FDI environment on FDI, which is largely attributable to FDI policy, by comparing the actual FDI inflow to expected/predicted value, which is computed from the estimated results. Table 3 shows the ratio of actual to predicted values for East Asian economies for 1990-2000. Singapore and China are overachievers for most years, while Taiwan and Malaysia are underachievers for most years. Performance for other economies is mixed. It is interesting to observe two types of groups among those economies with mixed performances. One group consists of Korea and India, whose performance improved in the

**Table 2. The Determinants of FDI Inflows**
**(Dependent variable= ln FDI Inflow)**

| | All Sample Economies | | | | Developing Economies | | | |
|---|---|---|---|---|---|---|---|---|
| | (1) | | (2) | | (3) | | (4) | |
| | coeffecients | t-stat | coefficients | t-stat | coeffecients | t-stat | coefficients | t-stat |
| ln GDP | 1.85*** | 9.91 | 1.83*** | 12.81 | 1.93*** | 7.53 | 1.91*** | 10.28 |
| GROWTH | 0.007 | 0.49 | 0.03*** | 3.18 | 0.02* | 1.70 | 0.03*** | 3.30 |
| GDPCAP | -0.00004** | -2.04 | -0.00003** | -2.00 | -0.0001* | -1.93 | -0.0001** | -2.18 |
| INF | -0.0004*** | -3.22 | -0.0003*** | -4.29 | -0.0003*** | 3.09 | -0.0003*** | -3.92 |
| EX | -8.5E-07 | -0.38 | -5.2E-07 | -0.19 | -1.2E-6 | -0.54 | -6.8E-7 | -0.24 |
| TRADE | 0.01** | 2.43 | 0.02*** | 6.02 | -0.002 | -0.49 | 0.01*** | 5.00 |
| EDU | 0.01** | 2.17 | 0.01*** | 2.77 | 0.02*** | 2.98 | 0.02*** | 3.09 |
| ELEC | 0.0002*** | 3.15 | 0.0001*** | 3.38 | 0.0004*** | 2.75 | 0.0001** | 2.00 |
| RISK | -0.0003 | -0.02 | | | 0.004 | 0.30 | | |
| c | -28.55*** | -6.31 | -26.91*** | -8.15 | -29.77*** | -4.93 | -28.28*** | -6.75 |
| R-sq | 0.641 | | 0.717 | | 0.454 | | 0.600 | |
| F | 45.35*** | | 71.55*** | | 31.84*** | | 48.60*** | |
| rho | 0.865 | | 0.818 | | 0.863 | | 0.759 | |
| chi2 | 45.04*** | | 110.08*** | | 2507.34*** | | 83.98*** | |
| observations | 518 | | 1157 | | 294 | | 881 | |

Note: F: H0: all beta are zero
rho: fraction of variance due to u_i
chi2: Hausman specification test
***, **, * indicate the level of statistical significance at 1, 5, and 10 percent.
Source: Author’s estimation

latter half of the 1990s, and the other group consists of Indonesia, Malaysia, the Philippines and Vietnam, whose performance deteriorated in the latter half of the 1990s.

**Table 3. Actual and Expected Value of FDI Inflows (ratio)**

| | Hong Kong | Korea | Singapore | Taiwan | Indonesia | Malaysia | Philippines | Thailand | Vietnam | China | India |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1990 | 0.97 | 1.20 | 1.11 | 1.44 | 1.10 | 2.03 | 1.81 | 3.08 | 1.64 | 0.85 | 0.47 |
| 1991 | 0.20 | 1.65 | 1.14 | 1.12 | 1.27 | 2.14 | 1.62 | 1.74 | 1.86 | 0.73 | 0.18 |
| 1992 | 0.59 | 0.89 | 0.44 | 0.68 | 1.25 | 2.14 | 1.54 | 1.34 | 2.03 | 1.43 | 0.64 |
| 1993 | 1.10 | 0.54 | 0.86 | 0.63 | 1.11 | 1.72 | 1.90 | 0.79 | 2.32 | 3.36 | 0.97 |
| 1994 | 1.49 | 0.50 | 1.30 | 0.84 | 0.85 | 0.82 | 1.67 | 0.40 | 2.47 | 2.19 | 1.28 |
| 1995 | 0.85 | 0.79 | 1.39 | 0.76 | 1.29 | 0.60 | 1.12 | 0.41 | 1.33 | 1.41 | 2.29 |
| 1996 | 1.74 | 0.92 | 1.15 | 0.85 | 1.54 | 0.73 | 0.84 | 0.52 | 0.71 | 1.25 | 2.50 |
| 1997 | 1.05 | 1.50 | 1.12 | 0.95 | 1.33 | 0.49 | 0.96 | 1.45 | 0.60 | 1.37 | 3.09 |
| 1998 | 1.33 | 2.38 | 1.03 | 0.09 | 1.28 | 0.25 | 1.08 | 1.09 | 0.48 | 1.24 | 2.44 |
| 1999 | 1.23 | 3.27 | 1.20 | 1.05 | 1.22 | 0.26 | 0.88 | 0.72 | 0.32 | 0.96 | 1.62 |
| 2000 | 1.12 | 2.94 | 1.22 | 1.70 | 1.12 | 0.21 | 0.68 | 0.47 | 0.19 | 1.04 | 1.55 |

Notes: The figures indicate the ratio of actual and expected FDI inflow values. The expected values are obtained from the estimated coefficients from equation (4) in Table 5.

These patterns reflect FDI environment of these countries, which are not captured by the explanatory variables, among which the quality of institutions such as governments and corporate sectors and FDI policies are very important. Indeed, the countries, which showed favorable FDI performance, such as China, Korea, India, and Singapore, improved FDI environment by liberalizing FDI policies or improving quality of institutions. By contrast, Indonesia, Malaysia, the Philippines, and Vietnam, whose FDI performance worsened, continue to have various problems including political instability and closed FDI environment.

## VI. Concluding Comments

This paper examined recent patterns of FDI flows in East Asia and tried to identify the factors that influence FDI flows. In the analysis policy framework for FDI was given substantial attention. Our analysis found that FDI inflows in East Asia began to decline around 2000 after experiencing steady and notable increase in the 1990s. Despite this overall trend, China is an exception in that its FDI inflows continued to increase in the 21st century, after a slight decline in 1999.

An examination of FDI policies for most East Asian developing economies revealed continuous liberalization, reflecting the recognition of the importance of attracting FDI in economic growth on the part of policy makers. However, we identified the need for further liberalization for many East Asian economies.

Turning to the analysis of the determinants of FDI inflows, we found the importance of large and/or growing market, educated low-wage workers, stable macroeconomic performance, good infrastructure, open economic system in order to attract FDI. Policy makers should improve upon these aspects by formulating and implementing appropriate policies.

For FDI recipients, exploiting the benefits of hosting MNCs' subsidiaries is important in order to promote economic growth, as MNCs have various firm-specific advantages such as technology, management know-how, well-developed procurement and distribution, which would contribute to economic growth of the recipient economies. Several cross-country statistical studies have found that availability of well-educated workers would help assimilate technology in the recipient countries. The issue of how to make best use of the presence of MNCs is very important, and further analysis is needed.

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## Appendix Table 1. Major FDI indicators

FDI Inflows

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | 208674.4 | 158821.3 | 166967 | 225495.3 | 255900.5 | 333811.5 | 384959.7 | 481911 | 686028.3 | 1079083 | 1392957 |
| Developing countries | 36958.5 | 43287.3 | 55301.1 | 81487.7 | 104293.7 | 114884.6 | 149758.8 | 193223.7 | 191283.9 | 229295.2 | 246056.6 |
| Brunei Darussalam | 3 | 1 | 4 | 14 | 5.89 | 582.76 | 653.6 | 701.74 | 573.25 | 747.61 | 549.16 |
| Cambodia | .. | .. | 33 | 54.12 | 68.9 | 150.7 | 293.7 | 168.1 | 242.9 | 230.28 | 148.53 |
| China | 3487 | 4366 | 11156 | 27515 | 33787 | 35849.2 | 40180 | 44237 | 43751 | 40319 | 40772 |
| China, Hong Kong SAR | 3275.07 | 1020.86 | 3887.47 | 6929.63 | 7827.94 | 6213.36 | 10460.17 | 11368.15 | 14765.6 | 24579.7 | 61939.3 |
| China, Macao SAR | 0.48 | 10.72 | -19.5 | -3.6 | 3.48 | 2.19 | 5.94 | 2.31 | -17.89 | 9.42 | -0.79 |
| China, Taiwan Province | 1330 | 1271 | 879 | 917 | 1375 | 1559 | 1864 | 2248 | 222 | 2926 | 4928 |
| of Indonesia | 1092 | 1482 | 1777 | 2003 | 2108 | 4346 | 6194 | 4678 | -356 | -2745.06 | -4549.98 |
| Korea, Republic of | 788.5 | 1179.8 | 728.3 | 588.1 | 809 | 1775.8 | 2325.4 | 2844.2 | 5412.3 | 9333.4 | 9283.4 |
| Lao People's Dem. Rep. | 6 | 6.9 | 7.8 | 29.9 | 59.2 | 88.4 | 128 | 86.3 | 45.3 | 51.61 | 34 |
| Malaysia | 2611 | 4043 | 5138 | 5741 | 4581 | 5815 | 7297 | 6323 | 2714 | 3895.05 | 3787.63 |
| Myanmar | 161.15 | 238.06 | 171.56 | 104.67 | 126.09 | 317.6 | 580.7 | 878.8 | 683.6 | 304.23 | 208 |
| Philippines | 550 | 556 | 776 | 1238 | 1591 | 1577 | 1618 | 1261 | 1718 | 1725 | 1345 |
| Singapore | 5574.75 | 4887.09 | 2204.34 | 4686.31 | 8550.19 | 11502.67 | 9302.95 | 13532.54 | 7594.25 | 13245.38 | 12463.84 |
| Thailand | 2575 | 2049 | 2151 | 1807 | 1369 | 2070.04 | 2337.65 | 3881.77 | 7491.16 | 6090.75 | 3350.25 |
| Viet Nam | 180 | 375.19 | 473.95 | 926.3 | 1944.52 | 1780.4 | 1803 | 2587.3 | 1700 | 1483.92 | 1289 |
| India | 236.69 | 75 | 252 | 532 | 974 | 2151 | 2525 | 3619 | 2633 | 2168 | 2319 |
| East Asia | 21633.95 | 21486.62 | 29367.92 | 52550.43 | 64206.21 | 73630.12 | 85044.11 | 94798.21 | 86539.47 | 102196.3 | 135547.3 |
| NIES4 | 10968.32 | 8358.75 | 7699.11 | 13121.04 | 18562.13 | 21050.83 | 23952.52 | 29992.89 | 27994.15 | 50084.48 | 88614.54 |
| ASEAN5 | 7008 | 8505.19 | 10315.95 | 11715.3 | 11593.52 | 15588.44 | 19249.65 | 18731.07 | 13267.16 | 10449.66 | 5221.9 |

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | 208674.4 | 158821.3 | 166967 | 225495.3 | 255900.5 | 333811.5 | 384959.7 | 481911 | 686028.3 | 1079083 | 1392957 |
| Developing countries | 36958.5 | 43287.3 | 55301.1 | 81487.7 | 104293.7 | 114884.6 | 149758.8 | 193223.7 | 191283.9 | 229295.2 | 246056.6 |
| East Asia | 21633.95 | 21486.62 | 29367.92 | 52550.43 | 64206.21 | 73630.12 | 85044.11 | 94798.21 | 86539.47 | 102196.3 | 135547.3 |
| US$ billion | | | | | | | | | | | |

Appendix Table 1. Continued

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | 208.6744 | 158.8213 | 166.967 | 225.4953 | 255.9005 | 333.8115 | 384.9597 | 481.911 | 686.0283 | 1079.083 | 1392.957 |
| Developing countries | 36.9585 | 43.2873 | 55.3011 | 81.4877 | 104.2937 | 114.8846 | 149.7588 | 193.2237 | 191.2839 | 229.2952 | 246.0566 |
| East Asia | 21.63395 | 21.48662 | 29.36792 | 52.55043 | 64.20621 | 73.63012 | 85.04411 | 94.79821 | 86.53947 | 102.1963 | 135.5473 |

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | 208.6744 | 158.8213 | 166.967 | 225.4953 | 255.9005 | 333.8115 | 384.9597 | 481.911 | 686.0283 | 1079.083 | 1392.957 |
| Developing countries | 36.9585 | 43.2873 | 55.3011 | 81.4877 | 104.2937 | 114.8846 | 149.7588 | 193.2237 | 191.2839 | 229.2952 | 246.0566 |
| Brunei | 0.003 | 0.001 | 0.004 | 0.014 | 0.00589 | 0.58276 | 0.6536 | 0.70174 | 0.57325 | 0.74761 | 0.54916 |
| Cambodia | #VALUE! | #VALUE! | 0.033 | 0.05412 | 0.0689 | 0.1507 | 0.2937 | 0.1681 | 0.2429 | 0.23028 | 0.14853 |
| China | 3.487 | 4.366 | 11.156 | 27.515 | 33.787 | 35.8492 | 40.18 | 44.237 | 43.751 | 40.319 | 40.772 |
| Hong Kong | 3.27507 | 1.02086 | 3.88747 | 6.92963 | 7.82794 | 6.21336 | 10.46017 | 11.36815 | 14.7656 | 24.5797 | 61.9393 |
| Macao | 0.00048 | 0.01072 | -0.0195 | -0.0036 | 0.00348 | 0.00219 | 0.00594 | 0.00231 | -0.01789 | 0.00942 | -0.00079 |
| Taiwan | 1.33 | 1.271 | 0.879 | 0.917 | 1.375 | 1.559 | 1.864 | 2.248 | 0.222 | 2.926 | 4.928 |
| Indonesia | 1.092 | 1.482 | 1.777 | 2.003 | 2.108 | 4.346 | 6.194 | 4.678 | -0.356 | -2.74506 | -4.54998 |
| Korea | 0.7885 | 1.1798 | 0.7283 | 0.5881 | 0.809 | 1.7758 | 2.3254 | 2.8442 | 5.4123 | 9.3334 | 9.2834 |
| Lao PDR | 0.006 | 0.0069 | 0.0078 | 0.0299 | 0.0592 | 0.0884 | 0.128 | 0.0863 | 0.0453 | 0.05161 | 0.034 |
| Malaysia | 2.611 | 4.043 | 5.138 | 5.741 | 4.581 | 5.815 | 7.297 | 6.323 | 2.714 | 3.89505 | 3.78763 |
| Myanmar | 0.16115 | 0.23806 | 0.17156 | 0.10467 | 0.12609 | 0.3176 | 0.5807 | 0.8788 | 0.6836 | 0.30423 | 0.208 |
| Philippines | 0.55 | 0.556 | 0.776 | 1.238 | 1.591 | 1.577 | 1.618 | 1.261 | 1.718 | 1.725 | 1.345 |
| Singapore | 5.57475 | 4.88709 | 2.20434 | 4.68631 | 8.55019 | 11.50267 | 9.30295 | 13.53254 | 7.59425 | 13.24538 | 12.46384 |
| Thailand | 2.575 | 2.049 | 2.151 | 1.807 | 1.369 | 2.07004 | 2.33765 | 3.88177 | 7.49116 | 6.09075 | 3.35025 |
| Viet Nam | 0.18 | 0.37519 | 0.47395 | 0.9263 | 1.94452 | 1.7804 | 1.803 | 2.5873 | 1.7 | 1.48392 | 1.289 |
| | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| India | 0.23669 | 0.075 | 0.252 | 0.532 | 0.974 | 2.151 | 2.525 | 3.619 | 2.633 | 2.168 | 2.319 |
| | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| East Asia | 21.63395 | 21.48662 | 29.36792 | 52.55043 | 64.20621 | 73.63012 | 85.04411 | 94.79821 | 86.53947 | 102.1963 | 135.5473 |
| NIES4 | 10.96832 | 8.35875 | 7.69911 | 13.12104 | 18.56213 | 21.05083 | 23.95252 | 29.99289 | 27.99415 | 50.08448 | 88.61454 |
| ASEAN5 | 7.008 | 8.50519 | 10.31595 | 11.7153 | 11.59352 | 15.58844 | 19.24965 | 18.73107 | 13.26716 | 10.44966 | 5.2219 |

Appendix Table 1. Continued

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| NIES4 | 10.96832 | 8.35875 | 7.69911 | 13.12104 | 18.56213 | 21.05083 | 23.95252 | 29.99289 | 27.99415 | 50.08448 | 88.61454 |
| ASEAN5 | 7.008 | 8.50519 | 10.31595 | 11.7153 | 11.59352 | 15.58844 | 19.24965 | 18.73107 | 13.26716 | 10.44966 | 5.2219 |
| China | 3.487 | 4.366 | 11.156 | 27.515 | 33.787 | 35.8492 | 40.18 | 44.237 | 43.751 | 40.319 | 40.772 |
| India | 0.23669 | 0.075 | 0.252 | 0.532 | 0.974 | 2.151 | 2.525 | 3.619 | 2.633 | 2.168 | 2.319 |

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Hong Kong | 3.27507 | 1.02086 | 3.88747 | 6.92963 | 7.82794 | 6.21336 | 10.46017 | 11.36815 | 14.7656 | 24.5797 | 61.9393 |
| Taiwan | 1.33 | 1.271 | 0.879 | 0.917 | 1.375 | 1.559 | 1.864 | 2.248 | 0.222 | 2.926 | 4.928 |
| Korea | 0.7885 | 1.1798 | 0.7283 | 0.5881 | 0.809 | 1.7758 | 2.3254 | 2.8442 | 5.4123 | 9.3334 | 9.2834 |
| Singapore | 5.57475 | 4.88709 | 2.20434 | 4.68631 | 8.55019 | 11.50267 | 9.30295 | 13.53254 | 7.59425 | 13.24538 | 12.46384 |

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Indonesia | 1.092 | 1.482 | 1.777 | 2.003 | 2.108 | 4.346 | 6.194 | 4.678 | -0.356 | -2.74506 | -4.54998 |
| Malaysia | 2.611 | 4.043 | 5.138 | 5.741 | 4.581 | 5.815 | 7.297 | 6.323 | 2.714 | 3.89505 | 3.78763 |
| Philippines | 0.55 | 0.556 | 0.776 | 1.238 | 1.591 | 1.577 | 1.618 | 1.261 | 1.718 | 1.725 | 1.345 |
| Thailand | 2.575 | 2.049 | 2.151 | 1.807 | 1.369 | 2.07004 | 2.33765 | 3.88177 | 7.49116 | 6.09075 | 3.35025 |
| Viet Nam | 0.18 | 0.37519 | 0.47395 | 0.9263 | 1.94452 | 1.7804 | 1.803 | 2.5873 | 1.7 | 1.48392 | 1.289 |

**Appendix Table 2. FDI Outflows to East Asian Countries**

($billion)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| World | 242.49 | 198.04 | 201.53 | 244.25 | 287.18 | 356.57 | 395.73 | 476.93 | 683.21 | 1096.55 | 1200.78 |
| United States | 30.98 | 32.70 | 42.65 | 77.25 | 73.25 | 92.07 | 84.43 | 95.77 | 131.00 | 209.39 | 142.63 |
| Japan | 48.02 | 30.73 | 17.22 | 13.71 | 17.94 | 22.63 | 23.43 | 25.99 | 24.15 | 22.74 | 31.56 |
| East Asia | 11.90 | 8.21 | 17.78 | 30.42 | 39.52 | 41.34 | 48.91 | 49.20 | 29.78 | 36.98 | 80.26 |

M&A and M&A shares in East Asia

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| M&A | 4.0 | 2.1 | 3.4 | 7.1 | 4.3 | 5.9 | 8.4 | 16.7 | 13.1 | 27.4 | 19.9 |
| M&A/FDI | 18.3 | 9.5 | 11.4 | 13.6 | 6.6 | 8.0 | 9.9 | 17.6 | 15.1 | 26.8 | 14.7 |

| | 1996 | 1999 | 2000 |
|---|---|---|---|
| Brunei | 47 | 0.0 | 0.0 |
| China | 56 | 8.0 | 0.0 |
| Hong Kong | 84 | 15.0 | 0.0 |
| Indonesia | 55 | 6.5 | 10.5 |
| Korea | 78 | 3.0 | 11.0 |
| Malaysia | 74 | 1.0 | 0.0 |
| Philippines | 66 | 12.0 | 5.0 |
| Singapore | 86 | 1.0 | 0.0 |
| Taipei | 75 | 3.0 | 5.5 |
| Thailand | 77 | 1.5 | 5.5 |
| Average | 72.6 | 4.3 | 3.6 |
| Japan | 86 | 0.5 | 5.5 |
| U.S. | 90 | 0.0 | 0.0 |

| | 1996 | 1999 | 2000 |
|---|---|---|---|
| Right of establishment | 6.3 | 6.6 | 7.3 |
| Examination procedure | 7.9 | 8.0 | 8.2 |
| MFN treatment | 7.6 | 8.6 | 8.6 |
| Profit repqtriation | 7.9 | 9.2 | 9.2 |
| Work permit | 7.6 | 7.6 | 7.7 |
| Taxation | 8.8 | 9.3 | 9.3 |
| Performance requirement | 8.5 | 9.0 | 9.2 |
| Protection of investors | 6.4 | 8.3 | 8.3 |
| Distpute settlement | 7.8 | 8.4 | 8.4 |
| Investment incentives | 6.7 | 6.9 | 6.9 |
| Capital exports | 7.0 | 8.1 | 8.1 |

| | 1996 | 1999 | 2000 |
|---|---|---|---|
| Right of establishment | 6.3 | 0.3 | 0.7 |
| Examination procedure | 7.9 | 0.1 | 0.2 |
| MFN treatment | 7.6 | 1.0 | 0.0 |
| Profit repqtriation | 7.9 | 1.3 | 0.0 |
| Work permit | 7.6 | 0.0 | 0.1 |
| Taxation | 8.8 | 0.5 | 0.0 |
| Performance requirement | 8.5 | 0.5 | 0.2 |
| Protection of investors | 6.4 | 1.9 | 0.0 |
| Distpute settlement | 7.8 | 0.6 | 0.0 |
| Investment incentives | 6.7 | 0.2 | 0.0 |
| Capital exports | 7.0 | 1.1 | 0.0 |

# Rapidly Increasing Economic Integration and Investment: Benefits & Challenges

***Dominique van der Mensbrugghe***
Lead Economist
World Bank

Thank you very much Mr. Chairman. First, let me say it's a great pleasure to back in Korea. Actually I had visited Korea but that was in 1990, so I haven't been here for 15 years. It is wonderful to be back. Let me thank to organizers who've done marvelous jobs with this workshop. The presentation today is basically the summary of the last year's global economic prospects report which is the World Bank's annual report on the global economy, each year we also focus on specific issue, last year's was on regionalism. So I'm going to talking about the main findings from that report. The report in general is quiet skeptical about regional trade agreement and it lays out a number of reasons why and I will delve into some of those as we go forward today. Let me remind the audiences of course that there's this flurry of activities toward signing additional regional trade agreement, let's not forget the original reason for creating GATT/WTO was to avoid kind of multi-polar and fractured world which we seem to be gravitating towards again as we move towards signing more these agreements. Basically I will cover four points in today's presentation. First is huge increase in regional trade agreements/ RTAs since 1990, then I will focus a little bit on the trade impacts of regional trade agreements and our interpretation of these impacts. Then I will briefly go over some of investment impacts. I actually think that we heard a lot about this in the last day and a half and there is not much more than I can add to the current discussion on that. Then I will raise few policy questions at the very end.

Starting with the regional trade agreements, so as I said, the last time I was in Korea was in 1990, since then as you can see from this chart, the number of signed RTAs least those have been notified to the WTO have increased quiet dramatically and cumulative right now we have 175 agreements in existence. The blue line is cumulative line and the bars are the annual notifications, so very large increase. Some of that of course was simply due to the fall of the iron curtain in 1990 so many of agreements are actually agreements within the new transition economies but also agreements between the EU and transition economies. Nonetheless, that being said, the number of agreements worldwide has been increasing quiet significantly; both north/south and south/south as well. Now, this is led to what is often referred to as spaghetti bowl of RTAs. This is an illustration of this, on the right hand side, you have Latin America, and on the left hand side you have Asia. You can see, most of the agreements right now according to this are in Latin America, in Asia right now there have been much fewer agreements. The average Latin American countries now part of seven regional trade agreements. In Africa, it's four. These countries are heavily engaged in this process. APEC of course just floated in, that was signed in 1989, it's a broader regional trade agreement, of course it's not in full implementation yet, but eventually one would imagine that it would gravitate towards that. Then more recently there have been a number of increasing regional trade agreements across the Pacific; bilateral agreements between Korea and Chile for example. So this creates quiet a number of problems, first diverts precious negotiating resources from the more important agenda which is Doha Agenda and it also makes managing the whole trade system much more difficult than in the world where MFN status is predominant.

What's been an impact on trade, I will show you a number of different slides one this. One right now just on the left-hand panel here is a number of RTAs and you can see that in 2002 the vast majority of RTAs were actually south/south agreements. USA is only party to very few agreements, and European Union, a quiet number more. But if you look at the percent of world trade covered, there is no correlation there between the number of RTAs that are signed and the percentage of world trade that is covered. So if you look again at the south/south portion, south/south trade it's a very small portion of world trade. On the other hand, USA which is party in 2002 to very few agreements, the trade covered by those agreements is a large share of world trade. Of course NAFTA is a big reason for that, the two biggest trading partners of United States are Canada and Mexico. But the title here is that regionalism is not necessarily integration. We can see that again in the next chart, here we've plotted exports as share of GDP on the horizontal axis and regional trade as share of GDP on the vertical axis. You can see that for example East Asia is highly integrated with the world but also highly integrated with itself even though by enlarge there is a lack of number of RTAs as they are in some of the other region. The other important factor behind this chart is that East Asia tends to have the lowest MFN tariffs amongst these broad regional groupings as well, so that there is an impact of low MFN tariffs and regional integration and integration into the global economy.

Another attempt at looking at the impact of RTA on trade performance, and one of the big issues in RTA is do they divert trade or create trade. This chart here is based on statistical model, it is called gravity model for those of you who are technically inclined where we try to find out how trade deviates, what would one expect in the absence of any agreements. So the first evidence you have here is that inter-regional trade has positive aspects so in the absence of agreement or let's say in the presence of disagreement, you see a very large increase inter-regional trade which one would expect, at least they should be doing that if nothing else. But when you put in the dummies for overall exports, overall imports, you can see that there is very wide variety of impacts here so that for some of these agreements on the top, you have South-African Customs Union, NAFTA, the EU, and few others, you can that overall these agreements have been trade-creating as well, so that has been increase broadly in trade, not just in inter-regional trade. But there are a number of agreements as you go down at the bottom here, if you look at COMESA and WAEMU which are both in Africa, those agreements have tended to decrease overall trade and this would have negative impacts. For Latin American countries, the evidence is mixed. In MERCOSUR it hasn't have much impact on overall trade even though inter-regional trade has gong up a lot and the same for the end impact.

So what do we conclude from this? We had two conclusions. One is the design of RTA is very important and at the top of list of course is having low external tariff barriers to begin with because that minimizes the risk of trade diversion. So that's number one. Rules of origin are very important and there's wide variety of rules of origin in these RTAs, so the emphasis there first of all is to have the least non-restrictive rules possible, the other is perhaps to have a little bit of uniformity in the way the rules of origin is applied because there's wide variety there as well. Exclusions are also important fact. The many of these RTAs do have an important exemption, very long phase in period that tends to diminish the economic benefits of this liberalization of services. Facilitating trade at the border can also have a very important impact. This is one area though where the RTAs have additional externalities because if you facilitate trade at the border, it not only helps trading with partners of RTAs but benefits also trading with non-partner members as well. Then there is an appropriate rule. The second big point here is implementation. A lot of agreements especially south/south agreements are poorly implemented and therefore the economic benefits that could be have from them are totally not forthcoming. That's the trade part. As you can tell from presentation, we are pretty negative overall on trade part. But RTAs of course do have many other components and I think on investment report comes out more positive although we do raise a number of issues. First of all, RTAs treat investment in many different ways so some of them for example have established pre-established limitations and market access, some have positive lists, some have negative lists, some come with dispute settlement mechanisms, others not, so there is wide variety of investment related agreements in RTAs. I am not sure if this list is visible to many of you but you can find it in the broader report. There are market differences in the way investment rules are applied. There is some numerical evidence that RTAs do attract more FDI, the number that's in the report is that a 10% increase in market size after the FTA has been formed is associated with a 5% increase in FDI in host country. I am not going to go into too much of these because we saw a lot of it yesterday, I thought Professor Charlton's exposition yesterday was quiet illustrative of many of these issues but obviously the channels are direct through liberalized market access, pay offs to greater integration, investor protections lower the cost, and then there are indirect including better policy regimes and an improved investment climate. So those are the major ones.

So let me now go to the concluding part which is about the unanswered questions. First of all, are the RTAs and investment flows and there I think one of the first question is, again some of these have been already dealt with already in the presentations yesterday and today is what is important for FDI?, is it the increase market access?, or is it the increase in the protection of the investment, or is it the package? Where does the balance lie? I think that's one of the critical issues, market access of course we don't always know how much new liberalization actually occurs. Then there are credibility effects, do the agreements lower the risk premium? is that what is driving FDI? What are the effects on the types of flows? For example, do regulations on intellectual property rights lead to increase investment on high tech investment? Again, we saw some of those issues raised yesterday in yesterday's presentations. The second major kind of unanswered question or policy issues, the effects on policy space. So for example, do the agreements limit the ability of government to deal with environmental regulations or public health regulations? I think there's fair amount of work that is going on this area right now. The third issue relates to international arbitration process, is it fair, transparent, or the outcomes consistent? Are there differences in the way large firms or countries are dealt with compared to small ones? What are the ways that the arbitration panels could be improved? We see some evidence of increased in the number of suits, this chart here shows the number of suits that are being presented to ICSID which is based at the World Bank, and you can see that there's been an increase over time. I think that's clearly the case as well with dispute settlement mechanism at the WTO on trade related issues and we can see an increase as well at the bilateral level for example between Canada, Mexico, and the United States. This is probably a positive outcome I suspect that these mechanisms are being used more and more but it does raise a number of issues on transparency and equity. Finally, there are the designs issues, again these have been dealt with in some of other presentations. To conclude, one of the big conclusions of the report is that the RTAs have to be crafted for individual pairs of countries. There is not one-size fits all, and this think was one of the messages from one of these presentations yesterday that the design of these is an art not a science and we really need to tailor these agreements to development needs of individual partners signing these agreements. Thank you very much for your time.

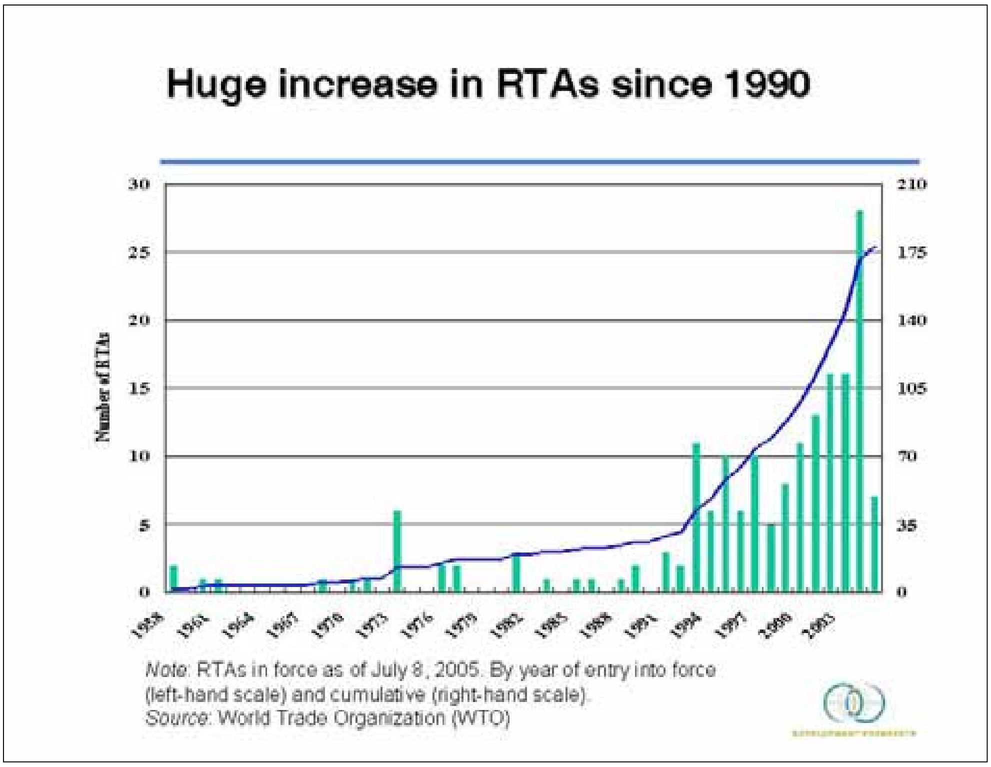
# Regional Trade Agreements: Implications for Trade and Investment

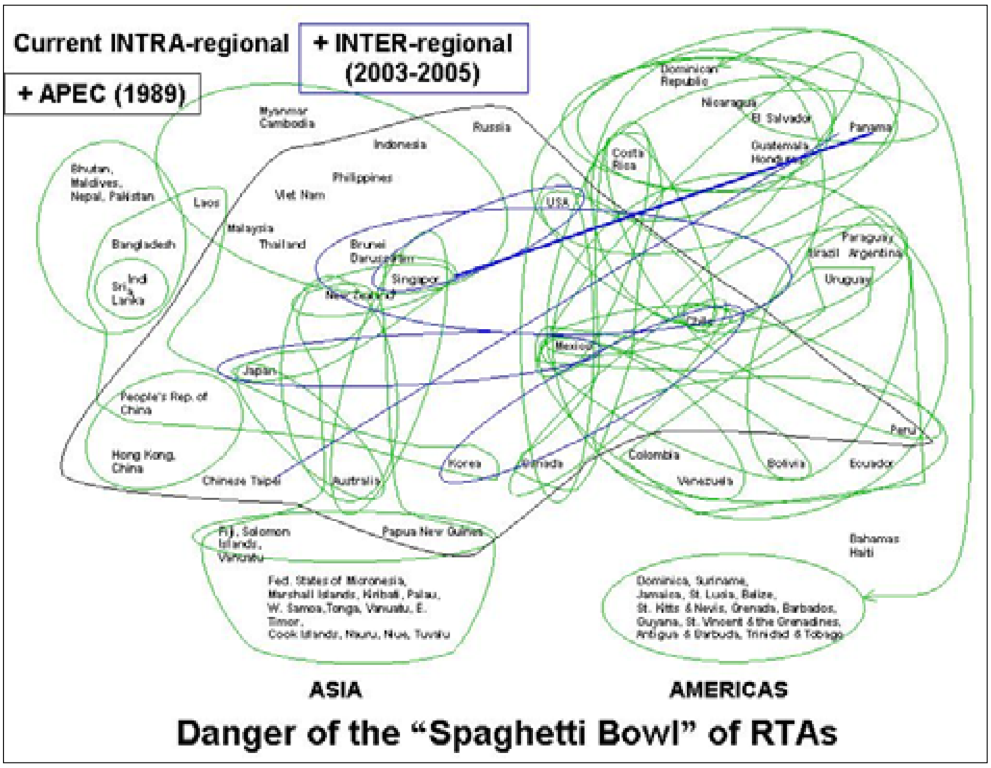
Dominique van der Mensbrugghe
The World Bank

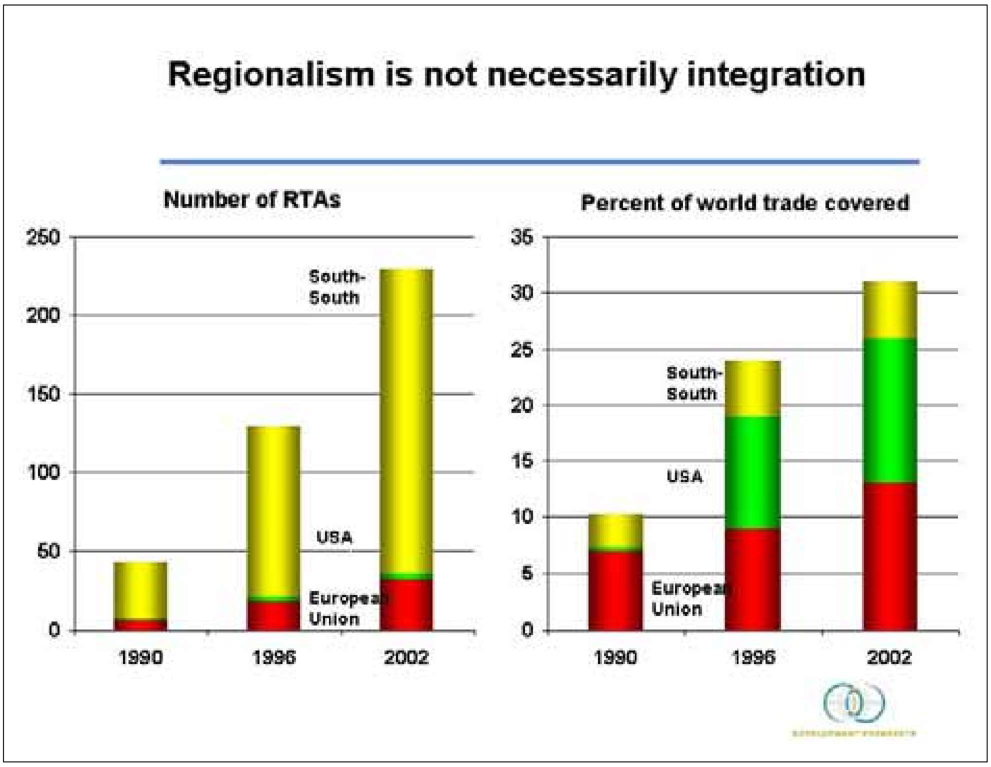
APEC-OECD Seminar
"Working Together on Investment for Development"
APEC Investment Opportunities 2005
"Towards Co-Prosperity Through Partnership"
Busan, Korea, 14-15 November 2005

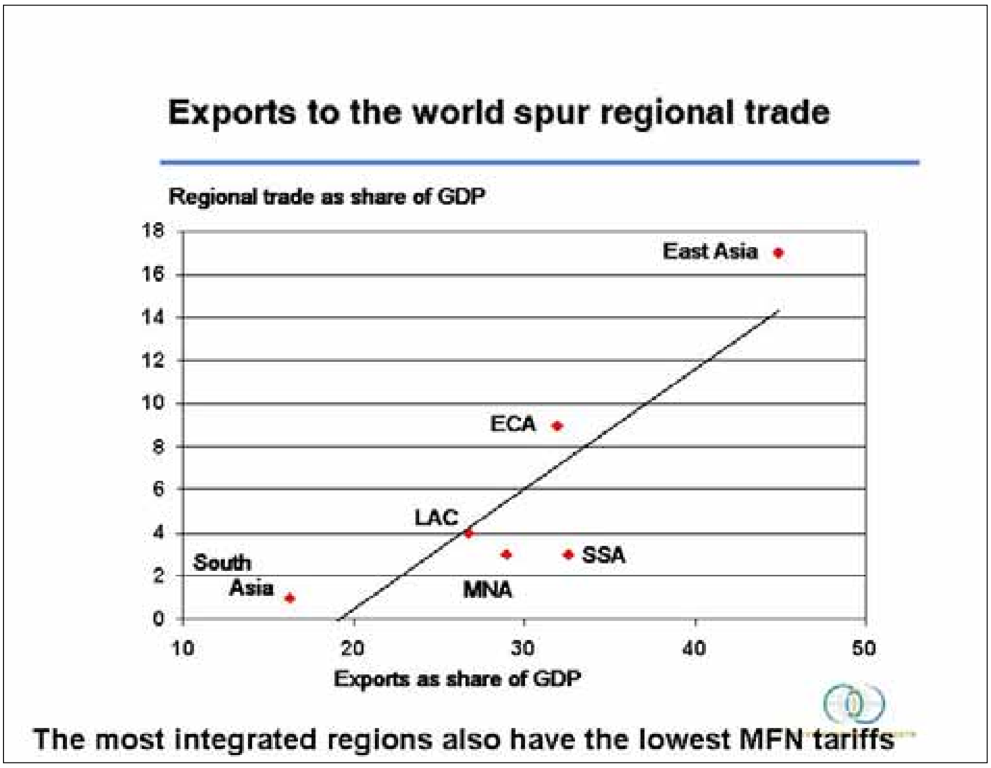
## Four points

- There has been a huge increase in the number of RTAs
- Effects on trade depend heavily on design
- International investment agreements through regional trade agreements (RTAs) now cover a large share of global investment, and RTAs contain quite different approaches to investment
- Several policy questions about economic consequences are still unanswered


Huge increase in RTAs since 1990
Number of RTAs
30
25
20
15
10
5
0
210
175
140
105
70
35
0
1958
1961
1964
1967
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
2000
2003
Note: RTAs in force as of July 8, 2005. By year of entry into force (left-hand scale) and cumulative (right-hand scale).
Source: World Trade Organization (WTO)

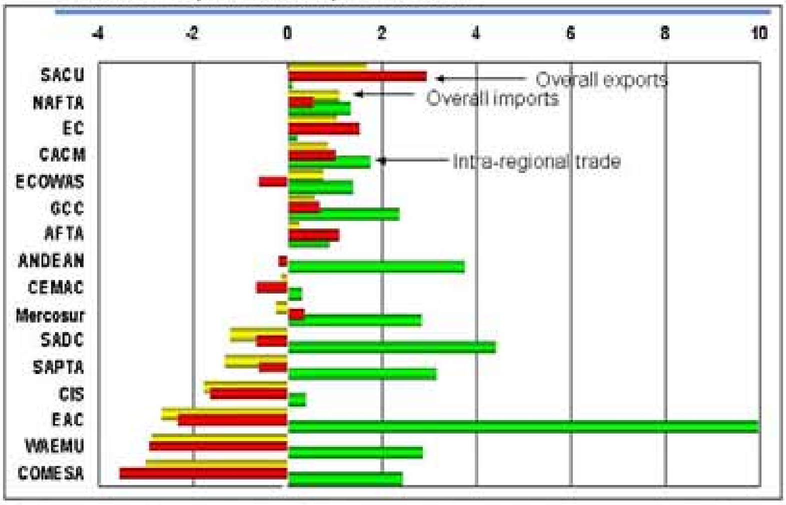

Current INTRA-regional
+ INTER-regional (2003-2005)
+ APEC (1989)
ASIA
AMERICAS
Danger of the "Spaghetti Bowl" of RTAs


Regionalism is not necessarily integration
Number of RTAs
250
200
150
100
50
0
South-South
USA
European Union
1990
1996
2002
Percent of world trade covered
35
30
25
20
15
10
5
0
South-South
USA
European Union
1990
1996
2002


Exports to the world spur regional trade
Regional trade as share of GDP
18
16
14
12
10
8
6
4
2
0
East Asia
ECA
LAC
SSA
South Asia
MNA
10
20
30
40
50
Exports as share of GDP
The most integrated regions also have the lowest MFN tariffs

## Do RTAs create – or divert – trade?

Estimated exponential impact on trade




*Note*: The bars show the magnitude of the dummy variables capturing respectively the extent to which intraregional trade, overall imports and overall exports differ from the "normal" levels predicted by the gravity model on the basis of economic size, proximity and relevant institutional and historical variables, such as a common language.

## Conclusion: "Open regionalism" works best

- Design
  - Low external tariff barriers
  - Nonrestrictive rules of origin
  - Wide coverage with few exclusions
  - Liberalization of services
  - Facilitating trade at borders
  - Appropriate rules
- Implementation: Avoiding paper agreements

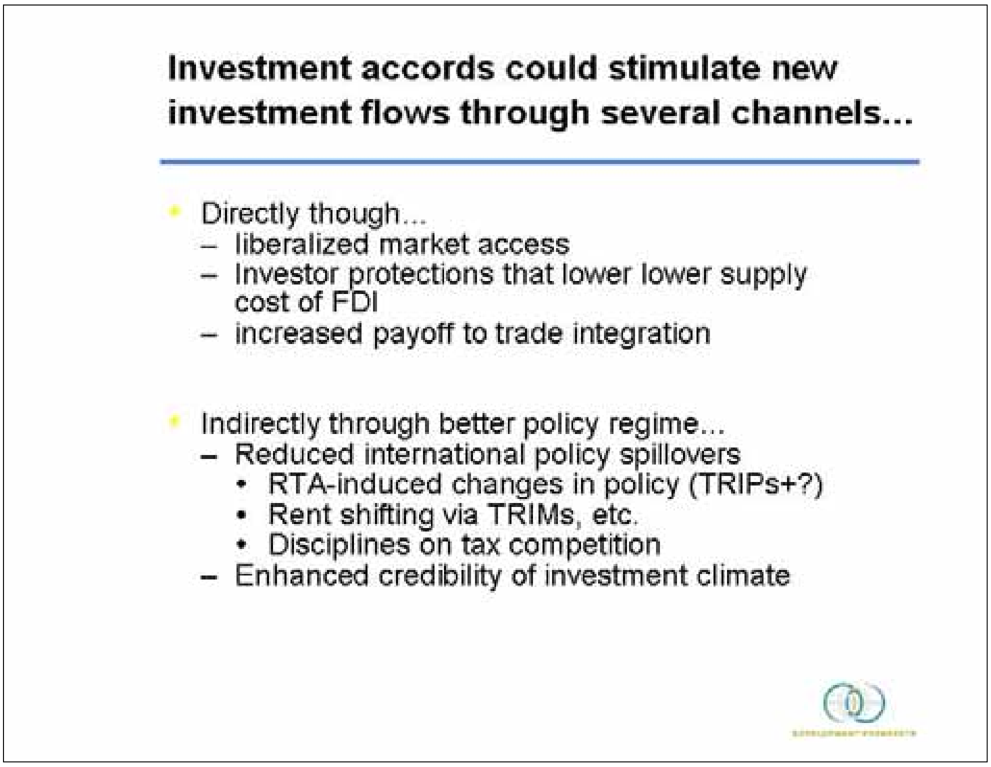
## RTAs frequently contain ample investment provisions…but these differ markedly across agreements

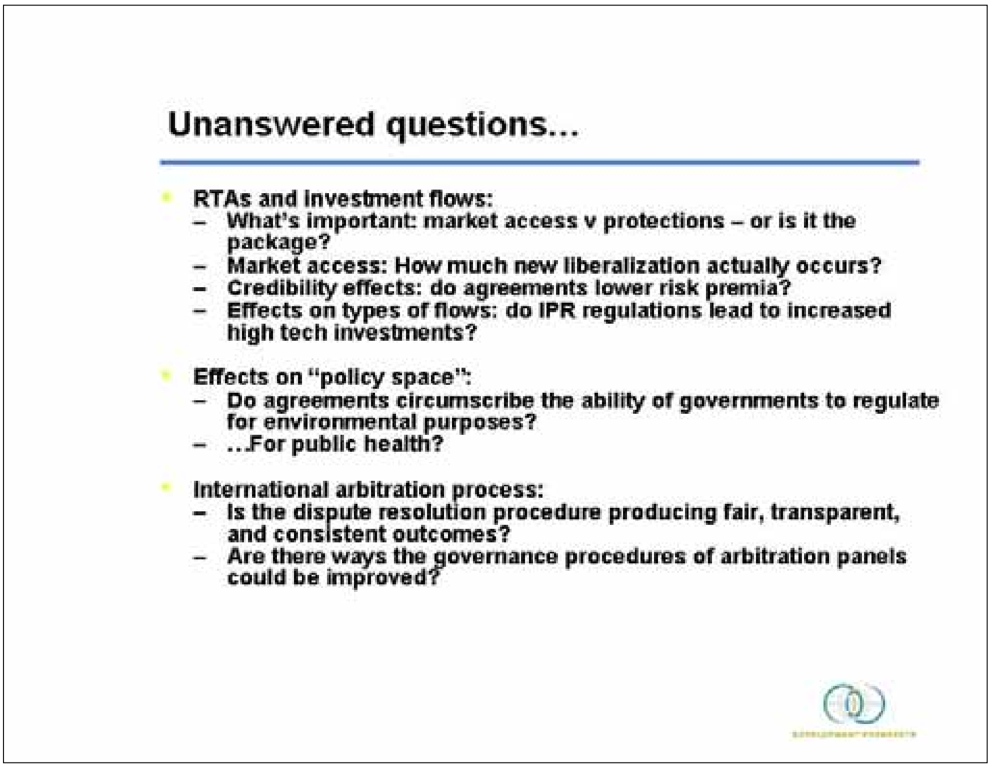
| | Services | | | | | Investment | | | | | Intellectual Property |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Agreements | National and MFN/Treatment Market Access | Rule of Origin (Nonrestrictive) | Pre-establishment & Limitations Market Access Exceptions | Right to Provide Services w/o establishment | Ratchet Mechanism | National Treatment/MFN Post establishment | Ownership Limitations | Pre-establishment Limitations | Ban on Performance Requirements | Investor-State Dispute Settlement | Intellectual Property |
| **U.S.** | | | | | | | | | | | |
| U.S-Jordan | Yes | Yes | Negative list | No | No | Yes | Negative list | Negative list | TRIMS+ | Yes | Yes |
| U.S-Chile | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | Yes | TRIPS+ |
| U.S-Singapore | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | Yes | TRIPS+ |
| U.S-Australia | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | No | TRIPS+ |
| U.S-CAFTA | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | Yes | TRIPS+ |
| U.S-Morocco | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | Yes | TRIPS+ |
| NAFTA | Yes | Yes | Negative list | Yes | Yes | Yes | Negative list | Negative list | TRIMS+ | Yes | TRIPS+ |
| **EU** | | | | | | | | | | | |
| EU-South Africa | No | No | No | No | No | No | No | No | No | No | Yes |
| EU-Mexico | Yes | Yes | Standstill | No | No | No | No | No | No | No | Yes |
| EU-Chile | Yes | Yes | Positive list | | | Yes | No | Positive list | No | No | Yes |
| **South-South** | | | | | | | | | | | |
| MERCOSUR | Yes | Yes | Positive list | No | No | Yes | No | Negative list | TRIMS+ | Yes | No |
| Andean Community | No | Yes | Positive list | No | No | - | No | Positive list | TRIMS+ | No | No |
| CARICOM | Not specified | Yes | Negative list | No | No | No | No | Positive list | No | Yes | No |
| Asean | Yes | Yes | Positive list | No | No | Yes | Yes | Positive list | No | Yes | No |
| SADC | No | No ? | | | | No | No | None | No | No | TRIPS |
| COMESA | Yes | No ? | Positive list | | | No | No | Positive list | No | No | No |
| **Other** | | | | | | | | | | | |
| Japan-Singapore | No | Yes | Positive list | No | No | | | | | Yes | Yes |
| Canada-Chile | Yes | Yes | Negative list | Yes | Yes | | | | | Yes | |
| Chile-Mexico | Yes | Yes | Negative list | Yes | Yes | | | | | | |

Source: Global Economic Prospects, 2005: Chapter 5

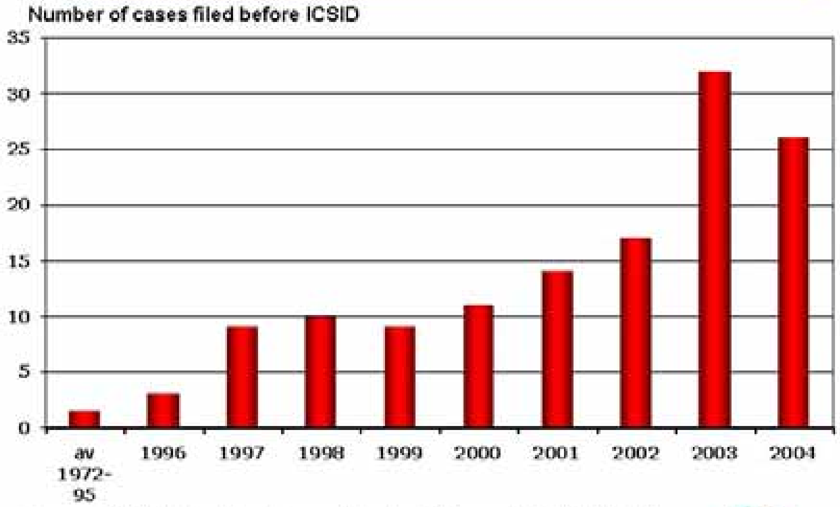
## RTAs do tend to increase investment flows

- RTAs that create large ex-post market results and, provided good investment climate, do attract more FDI.
  - A 10% increase in post-FTA market size is associated with a 5 percent increase in FDI in the host country.
- However, what are the drivers?


Investment accords could stimulate new investment flows through several channels…
Directly though…
– liberalized market access
– Investor protections that lower lower supply cost of FDI
– increased payoff to trade integration
Indirectly through better policy regime…
– Reduced international policy spillovers
• RTA-induced changes in policy (TRIPs+?)
• Rent shifting via TRIMs, etc.
• Disciplines on tax competition
– Enhanced credibility of investment climate


Unanswered questions…
RTAs and investment flows:
– What's important: market access v protections – or is it the package?
– Market access: How much new liberalization actually occurs?
– Credibility effects: do agreements lower risk premia?
– Effects on types of flows: do IPR regulations lead to increased high tech investments?
Effects on "policy space":
– Do agreements circumscribe the ability of governments to regulate for environmental purposes?
– …For public health?
International arbitration process:
– Is the dispute resolution procedure producing fair, transparent, and consistent outcomes?
– Are there ways the governance procedures of arbitration panels could be improved?

## Investor state suits are increasing…




*Source:* ICSID Lists of Pending and Concluded Cases (ICSID Website), April 2, 2005

## Unanswered questions…

- **RTAs and investment flows:**
  - **What's important: market access v protections – or is it the package?**
  - **Market access: How much new liberalization actually occurs?**
  - **Credibility effects: do agreements lower risk premia?**
  - **Effects on types of flows: do IPR regulations lead to increased high tech investments?**
- **Effects on "policy space":**
  - **Do agreements circumscribe the ability of governments to regulate for environmental purposes?**
  - **…For public health?**
- **International arbitration process:**
  - **Is the dispute resolution procedure producing fair, transparent, and consistent outcomes?**
  - **Are there ways the governance procedures of arbitration panels could be improved?**
- **Design issues:**
  - **Are local firms, w/o recourse to international arbitration, placed at a disadvantage v. foreign firms?**
  - **Policy spillovers – Should tax incentives be disciplined?**

# Rapidly Increasing Economic Integration and Investment: Benefits & Challenges

***Marie-France Houde***
Senior Economist
Investment Division, OECD

Ladies and gentlemen. Good morning

**How much investment do OECD investment agreements protect ?**

I would like to share with you today some of the preliminary findings of the work which we have recently carried in assessing the volume of investment covered by OECD investment agreements. This study is part of a comprehensive stocktaking exercise recently undertaken by the Investment Committee on the novel features of bilateral investment treaties (BITs) or investment chapters in free trade agreements concluded by OECD countries.

This work is indeed complementary to the work of the World Bank as just described by *Mr. Van der Mensbrugghe.*

The question of the volume of investment covered out by investment agreements is an interesting one because the proliferation phenomenum of such agreements is usually characterized in terms of numbers and not in terms of volumes covered. Obviously the volume of investment affected by investments agreements is a crucial issue, if not, in the end the most important one. The assessment we have carried out with respect to OECD agreements, is, to our knowledge, the first of its kind.

## Three major conclusions emerge from our analysis:

First, while the number of investment agreements concluded by OECD countries is rather high -- we have estimated it to be around 1240 as of July of this year, representing over half of the agreements in existence, they only relate to about 18% and 15 % of OECD countries outward or inward FDI direct investments respectively. This apparent paradox can be explained by the fact that while the bulk of OECD agreements have been contracted with non-OECD countries, the majority of OECD investments -70 to 80 % depending of the years -still take place among OECD countries in the absence of BIT ot TAs coverage. There are however, important differences between countries and agreements.

Second, it would appear the dynamic is shifting away from BITs in favour of broader economic co-operation agreements devoted to trade, intellectual property protection, competition policy, trade and investment facilitation , which I will refer in this presentation as trade agreements as well as investments. For example, only 10 new BITs have been contracted by OECD countries in the first half of this year as compared to 107 BITs in the peak year of 1996. The number of TAs with investment content, on the other hand, is growing rapidly. According to our calculations, there are already 36 OECD trade agreements in existence, most of them concluded since the coming into force of NAFTA in 1994, most of them after the year 2000. Furthermore this trend is accelerating with more than 40 new TAs under negotiation or awaiting ratification.

The third major conclusion is that OECD investment agreements not only protect OECD outward investments but also investments into OECD countries. In other words, OECD agreements are not a one way street. This is particularly true for the agreements recently concluded by Australia, Canada and Mexico where the level of treaty protection afforded by IIAs is quite significant. The incremental coverage envisaged under future agreements is also particularly important in the case of Korea and Japan.

Before providing more details, I would like to say a word on the methodology followed in our study. We have used FDI statistics as a proxy for investment agreements coverage and this for essentially three reasons. First we had at our disposal a unique data base on FDI that provides detailed information on OECD bilateral flows. But most importantly, FDI constitutes the major source of external financing in developing countries, which are OECD main investment treaty partners. We also deliberately used "stocks" because they correspond closely to the asset-based definition which is now generally being used in recent investment agreements.

## Let now me turn to other interesting findings:

European countries are responsible for the largest number of OECD bilateral investment agreements. As a matter of fact, six European countries - Germany which concluded its first BIT with Pakistan in 1959 -- Switzerland, the United Kingdom, France, the Netherlands and Italy account for over half of the OECD total. However the amount of outward investment protected by these BITs rarely exceeds 10 per cent of European investments abroad, except for Austria's agreements which capture 37 % of their outward investment and for Spanish agreements which cover 25% of these investments. This apparent low coverage needs to be seen against the fact that the bulk of European investments is directed at other European countries, which benefit from the high standards of EU and EEA treaties When this consideration is taken into account, the level of treaty protection exceeds 60 per cent. But there are differences between "old' and "new" Europe. Poland, Hungary and the Slovak Republic direct a larger share of their investments outside the EU and thus show a higher treaty coverage of their investment abroad -- 88 %, 65% and 50% respectively. The level of protection granted by these countries to inward direct investment is also very high.

Korea, whose BIT tradition goes back to 1967, also has a relatively high percentage of protection- 53 %. Japan, on the other hand, who embarked very recently into the process, has a comparatively small percentage -12%-- protected.

The lowest levels are recorded however by Australia, Canada and the United States. Where the level of BIT protection never exceeds 5%.

A radically different situation can be observed for OECD trade agreements with investment content. Four countries -- Mexico, the United States, Australia and Canada -- account for 90% of these agreements. Their investment coverage is also very high both as regards outward and inward investments: respectively 60 % and 32 % in the case of Australia, 44% and 64 % in the case of Canada and 20 % and 10 % in the case of the United States. The new agreements which these countries are contemplating are also expected to accentuate this trend. Japan and Korea provide typical examples of the shift in favour of trade agreements to the detriment of BITs. The proportion of outward investment to be captured by new Japanese agreements is expected to raise from 3.8% to 16 %.

On the European side Switwerland is the only European country to contemplate new trade agreements. There is a fundamental reason for this. EU Member states and the European Commission share competence in regard to international investment and it is the European Commission which is responsible for the negotiation of trade agreements. The investment related provisions of the ten agreements concluded by the EU with non-Member States are generally not very comprehensive and do not generally contain strong legally-binding obligations. The volume of investment covered is also relatively quite small.

I hope that you have this information of particular interest. It could be extended to APEC as well as well as to other major major economies such as India which has recently concluded a major trade agreement with Singapore. The analysis we have conducted however does not do away with the need to assess the quality of the commitments of investment agreements. This work is currently been pursued by the OECD Investment Committee and we also look forward to share this analysis with you in the near future.

Thank you very much.

# Session 2: Lessons and Options for Future Cooperation

**Presentations**

Mr. Roy Nixon, Convenor, APEC Investment Expert Group
Mr. Joachim Steffens, Investment Committee, OECD
Ms. Marie-France Houde, Senior Economist, Investment Division, OECD

# Lessons and Options for Future APEC-OECD Cooperation

***Roy Nixon***
Convenor
APEC Investment Expert Group

Thank you, Alan.

APEC and OECD, it's not surprising that we should seek to do joint things together. We both pursue the goal of reducing barriers to trade and investment and strengthening regional cohesion. Our work involves seeking ways to reduce red tape, to reduce bureaucracy that prevents people in business from selling their skills internationally. We both undertake detailed economic analysis on a wide range of subjects, which are of mutual interest. In many instances cooperation and the systematic exchange of information can prevent waste in the use of resources.

Let's just look at the story briefly so far of cooperation between these two organizations. It's not new, as evidenced by joint work in areas like regulatory reform. This dates back to 2001 when we have the APEC-OECD cooperative initiative on regulatory reform. This provides a forum for the multi disciplinary discussion to deepen understanding on regulatory reform as a vector for stimulating economic productivity and growth. There have been several workshops and lots of work in cooperation. This resulted in APEC and OECD finalising an integrated checklist for self-assessment on regulatory competition and market openness policies, for members to implement those principles. We also have significant cooperation on telecoms including guidelines for the security of information systems and networks. In the area of the digital economy, we have developed ways together to extend access to the digital economy and the Internet to the people in APEC member economies. On small to medium sized enterprises, APEC and OECD had agreed to undertake a collaborative project and I understand that we've also agreed to work on insolvency issues.

On investment, our form of cooperation started in Pucon with a seminar on international investment where we brought together as we have here, a diverse range of APEC and OECD investment delegates, private sector representatives, government officials, negotiators, organizations such as OECD, UNCTAD, etc. and international arbitration specialists. The seminar discussed a range of issues as we have here of mutual interest to advance and explore further ways of cooperation among both forums regarding investment. Since that time, and certainly from beginning of this year, it's been my plan to increase our cooperation. I invited OECD to come to our IEG meetings in Jeju and Gyeongju meeting (they were only able to attend the latter) and was pleased that they were able to join us in Tokyo for the APEC investment facilitation seminar, jointly organized by Japan and UNCTAD. OECD was able to add significantly to the discussion of trends, approaches to key and emerging issues and interaction and coherence among international investment agreement including its recent work studying OECD member countries bilateral investment treaties and investment chapters of free trade agreements.

OECD also attended our IEG meeting in Gyeongju a few days later where IEG was given a detail rundown on OECD work on features and trends in international investment agreements, the Policy Framework on Investment (PFI), and investment statistics. And responding to questions from the floor, the OECD also informed the IEG about the work it does in areas like bribery and corporate social responsibility through the OECD Guidelines for Multinational Enterprises.

The arrangement at the moment is presently at hoc in the sense that we invite them on a meeting by meeting basis. I think there may be potential scope in the future to find a more permanent observer arrangement.

The two events held in September, and the event we're participating in here today, clearly show the scope to exploit synergies between APEC and OECD. At the Tokyo UNCTAD seminar we were able to all share work we've been doing on these emerging issues. UNCTAD contributed research identifying trends in BITs and investment chapters of FTAs and OECD shared the results of its recent investment agreement stock take, which showed how little FDI is protected by OECD North/South BITs compared to the FDI coverage in free trade agreements. APEC was also able to share information on its recent best practices for FTAs. Another interesting interaction at the IEG meeting was the sharing of information between OECD and APEC's business community. For example the OECD's work on developing the PFI was of interest to ABAC. In reverse the work taken by the ABAC Finance Working Group on impediments to foreign direct investment in the financial services sector was of interest to the OECD. Dialogue between the APEC and the OECD business communities is also a possibility. It certainly brought home to me that we cannot take for granted that we all know what each of us is doing.

So where can we cooperate more together on investment? One of the most important common goals of IEG and the OECD Investment Committee is to promote investment for development. The OECD initiatives for development, the PFI, which we've heard so eloquently talked about over the last day or so was launched in 2003 and is intended as a contribution to the effective implementation of the Monterrey consensus. Out of that we have a tangible product. The PFI covers policy areas such as trade, corporate governance, competition, tax, public governance, we've seen some of these and we've discussed some of the issues arising over the last day or so. And at the core of this framework is a non-prescriptive and coherent checklist of issues for consideration by any interested governments engaged in domestic reform. What may come out of this is a very useful benchmark against which APEC Member economies can self-assess or be peer reviewed on their investment policy environment.

Regional cooperation or multilateral policy dialogue, aimed at creating an environment that is attractive to domestic and foreign investors is an important objective as this enhances the benefits of investment for all society. The OECD has experts tracking new developments in recent investment agreements and undertakes in depth analysis of core treaty provisions. Recent work and some under way, deals with a new body of state practice and jurisprudence. Issues studied include familiar concepts such as MFN, fair and equitable treatment, national treatment, indirect expropriation and improvement in investor-state dispute settlement mechanisms. All of this is a valuable work for IEG including its upcoming work on reviewing the Non-Binding Investment Principles and identifying the common elements in investment chapters of RTAs and FTAs.

OECD has a long established history, in the implementation of investment agreements and standards among its members. It has strong credentials in analyzing and reviewing foreign investment regimes through peer review. While these peer reviews are focused in performance against established treaties and provisions, they are oriented towards producing policy advice and how to solve identify problems. A good example is China. In 2003 the OECD undertook an investment policy review of China and recommended a number of policy options to enable China to attract more and better FDI by developing a more open and transparent rules based investment environment. These options included relaxing remaining foreign ownership restrictions, streamlining foreign investor project approvals and better protection of intellectual property rights through a stronger rule of law.

Now I understand China has implemented some of these policy recommendations. And there has been useful follow-up work. The OECD is undertaking now a North East China pilot project to develop open policies towards cross border mergers and acquisitions. Partly because of obstacles to cross border M&A persist in the region, and China as a whole. The regulatory framework for cross border M&A remains fragmentary over complex and incomplete. And I understand that part of this in depth study has been fact finding, a questionnaire to actual and potential acquirors of Chinese companies and a joint seminar with government officials from both central and provincial bureaucracies. The final activity in this study is an OECD China symposium on China's policy towards cross border mergers and acquisitions being held next month in Beijing.

This kind of hard headed policy advice if implemented can be of great importance in tangibly improving the investment environment in the economies studied. While APEC may not be ready to adopt this template for its analysis and review activity, it certainly warrants further study.

So to summarize, it seems clear to me from this overview that OECD and APEC have a "natural fit" for each other with large scope to engage in policy dialogue and enhance cooperation. OECD has a long history in implementation of investment agreements and standards. It has strong credentials in analyzing and reviewing foreign investment regimes through peer review. In the next 1-2 years, APEC should consider formalizing its links with OECD at the working group level; it should consider how it might use the PFI once it's endorsed by OECD ministers in 2006. We might like to consider how we might get the OECD to help us develop our own capacity, to undertake detailed policy analysis and review. Finally, we need this cooperation at the working group level. It's very good to have joint seminars and cooperation of this sort. But it's the day today that working level experience that from which we will most benefit.

Thank you.

# APEC-OECD Seminar

## Lessons and options for future APEC-OECD Cooperation

Roy Nixon, Convenor,
Investment Experts Group

## A natural fit?

- It is not surprising that APEC and OECD should seek to undertake joint activities:
  - similar organisations with similar objectives
  - both publish economic analysis and reports of mutual interest
  - both pursue economic reform so as to increase trade and investment, create more jobs and improve the wellbeing of our respective people.

## The story so far….

- Cooperation between OECD and APEC is not new especially in areas like regulatory reform, telecommunications, small and medium enterprises and the digital economy

- 1st APEC/OECD seminar on international investment, Pucón, Chile, May 2004 on "Current FDI Trends and Investment Agreements: Challenges and Opportunities"

## Follow up activities

- IEG has moved to invite OECD to its meetings:
  - In May, OECD unable to come due to other work commitments;
  - In September, a representative from OECD attended both:
    - *APEC Investment Facilitation Initiative: A Cooperative Effort with UNCTAD and other Multilateral Institutions* was held on 1-2 September, in Tokyo
    - IEG meeting in Gyeongju
  - Arrangement is presently ad hoc but more formal arrangements may be possible in the future

## Useful synergies to exploit

- Organisations such as APEC, OECD and UNCTAD are all working extensively on emerging issues in the international investment agreement area:
  - Scope for increased collaboration:
    - Identify issues of mutual interest and seek to involve each other cooperatively;
    - Avoid reinventing the wheel
  - Involve our business communities wherever possible as they are working too
-

## Where can we cooperate?

- Investment for development:
  - OECD is looking to increase the capacity of non-members to attract more investment by:
    - engaging in dialogue;
    - sharing "best practices" for promoting a favourable environment for both foreign and domestic investment.
    - APEC is looking at “common elements” in its Best Practices for RTAs/FTAs and OECD is developing the Policy Framework for Investment
- Developing better investment agreements:
  - To reinforce the gains from domestic deregulation and to provide greater protection for investors
  - The need to understand the increasingly complex environment relating to these agreements
  - Helps improve outcomes for all

## Where can we cooperate?

- Policy analysis and review:
  - OECD has a well established capability to analyse foreign investment regimes through peer review processes
  - Concrete outcomes include policy recommendations on how to solve identified problems
  - Good examples involving APEC member economies are the OECD reviews of Russia and China:
    - Often this policy advice is ongoing as part of a long term program aimed at improving the environment for business investment in the economy concerned

## In summary

- OECD and APEC are a natural fit and scope for continuing policy dialogue and cooperation is large
- Investment is an area where OECD has strong credentials and much to offer
- Possible activities in 2006-2007 include
  - the Policy Framework for Development
  - Continued joint projects of mutual benefit to increase our understanding of complex issues in investment agreements
  - Further policy dialogue including how we might develop our own capacity to undertake in-depth policy analysis and peer review
  - Looking to formalise our cooperative arrangements at the working group level

# Lessons and Options for Future Cooperation

***Joachim Steffens***
Investment Committee, OECD

- The proliferation of bilateral investment treaties and more recently, the inclusion of investment disciplines in regional trade agreements are no doubt one of the most important developments on the international scene we have witnessed in years.

- The basic aim pursued has been the protection and promotion of investment flows, notably into countries needing them the most but presenting high risks for foreign investors.

- A number of questions have arisen lately about the consequences of this unprecendent phenomena. Are these agreements worth the effort? Do they really have a positive impact on investment flows? Do they unduly constrain the policy pace of host governments and their ability to regulate for the benefit of their people? Do they expose governments to frivolous and costly claims on the part of aggressive investors and lawyers as the rise of investment disputes may let us believe? Does it make a difference to include investment disciplines in trade agreements or to negotiate them separately? If so, is the rise of broader trade agreements compatible with the maintenance of an open and non-discriminatory world? Is the spectrum of the 1930's coming to haunt us again? Do we have other choices now that investment has been dropped from the Doha Development Agenda? How can we rip the benefits of these agreements and avoid potential downside risks?

- These are some of the questions we will try to address in this session. We will benefit of the insight of eminent experts in this field. Professor Newmayer from the London School of Economics and Political Science has produced recent evidence of the impact of investment agreements. He has also extended this analysis of double taxation agreements which are also an important consideration in any decision to decision. Professor Shujiro Urata from Waseda University will inform us of trends in the RTA/FTA Architecture of the Asia-Pacific Region, which has gained prominence since the Asian Financial crisis in 1997. Mr. Dominique Van der Mensbrugghe, Senior Economist from the World Bank, will highlight the main findings of the Global Economic Prospects 2005 especially devoted to the rise of regional economic integration agreements. Finally, Mme Houde from the

OECD Secretariat will highlight some original research done in the OECD on the coverage of OECD investment agreements. Our discussants will bring the perspective of “practionners” and we will also have the opportunity to listen to them.

- This is an important session. There is no coincidence the APEC Investment Experts Group is being called upon to give its views in the development of APEC Guidelines for RTAs that are open to the world. We too in the OECD Investment Committee are devoting special attention to this issue. We have undertaken a major stocktaking exercise of new features of investment agreements as to see more clearly their most positive as well as perhaps no so positive aspects. We clearly can work together in this field.

# Lessons and Options for Future Cooperation

***Marie-France Houde***
Senior Economist
Investment Division, OECD

- The discussions in the last couple of days have shown the breath of the interests shared by APEC and the OECD in the investment field. Not only the OECD and APEC are pursuing similar liberalization goals but they also share consensual working methods, also known as the peer review approach.

- This is also often referred to as a "soft law" to compliance which some consider not a very effective method for moving things forward.
- Our experience in the OECD proves that is not the case. Peer review and its companion "peer pressure" have proven to be particularly suited for building policy capacity in particularly complex situations. And building an enabling environment for investment is indeed a complex task.

- This complexity results from the large number of policy communities, institutions and influences that affect the business environment (formal and informal, government and business, domestic and international), from the diversity of human interactions and economic transactions that take place and from exogenous factors such as technological or structural change, not to mention geography, weather or resource endowments. It may not coincidence that the Policy Framework for Investment is so breath taking and that the menus of options and actions plans for implementing the Bogor Goals have been expanding over the years.

- The most direct consequence of this increased policy complexity is that there are no one-fit-all solutions - the same policy action in two different environments will have two different impacts. Policy-makers do need to find their own solutions. Fortunately, they are not alone in this undertaking. They may learn from each other by exchanging information and experiences, giving each other advice or assistance and over time develop a "pool of good policy practice" on which they can draw to develop their own policies. International organizations such as APEC and the OECD can also help by creating "international communities of investment policy practices" on which policy practitioners can draw to pursue their own reform efforts.

- If peer review has proven in the OECD to be a well suited capacity building mechanism for addressing complex and inter-disciplinary issues, there are some prerequisites for this method to work. Among other things:
  - The benchmarks for evaluation and recommendation that are used must be well adapted to the task at hand.
  - To be effective, peer review requires a significant engagement on the part of the country reviewed and other actors in the process. OECD experience shows that this entails a thorough inter-agency preparation by the reviewed government and readiness to follow through the review's recommendations and peer monitoring.
  - Peer review should also be based on independent analysis carried out by knowledgeable experts;
  - Peer reviews should involve government officials responsible for investment policy design and implementation;
  - The participation of countries from different regional perspectives and levels of development is an advantage. This enables to test different approaches and experiences.
  - Investment policy reviews should also be conceived as a living tool allowing for flexibility in taking up new issues. They should provide an input into the collective development of new best practices.

- The OECD will soon be turning to putting the Investment Policy Framework "into practice" and the lessons drawn from the Mid-term stocktaking exercise on the implementation of the Bogor goals will be presented to Ministers at the APEC Summit later this week. As you have said Mr Nixon it would appear both timely and desirable to discuss how the APEC's experience with the implementation of the Bogor goals could be integrated with the OECD's experience with the Policy Framework for Investment. Furthermore conducting peer reviews, possibly jointly, would also be one of the good ways for enhancing this cooperation.

Thank you very much.

# Closing Remarks

Mr. Choi, Pyeong-Rak, Director General, Ministry of Commerce, Industry and Energy of Korea

Mr. Mats Isaksson, Head, Corporate Affairs Division, OECD

Mr. Alan Bowman, Chair 2004-2005, APEC Committee on Trade and Investment

# Closing Remarks

***Pyeong-Rak Choi***
Director General
Ministry of Commerce, Industry and Energy of Korea

Good morning everyone. Mr. Alan Bowman, Chair of APEC Committee on Trade & Investment Liberalization, Mr. Mat Isaksson, Head of OECD Corporate Affairs Division, and Representatives from international organizations and APEC member economies, thank you for your lively and insightful discussions during the two-day seminar.

On the occasion of the 13th APEC Summit, the APEC/OECD Joint Seminar was organized to provide opportunities for policy- makers and investment experts from APEC member economies and international organizations to exchange their views on FDI promotion policies and global trends. For two days, the joint seminar covered various aspects of FDI -- the latest global trends, the effectiveness of target strategies, the consequences of the WTO trading system, corporate governance for investment, the impact of FDI on economic integration, and future international cooperation. I believe that our discussions will aid investment experts, not to mention that it will help me, as the Director General responsible for Korea's foreign investment policy.

FDI is more than a flow of capital. Not only does FDI contribute to domestic production, employment, and exports, but it promotes competition and hence consumer welfare, and also the transfer of technology, and management practices. As corporations continue to reorganize and the number of M&As rise, trans-national companies are taking advantage of overseas outsourcing in the service sector and relocating their R&D centers abroad. The Korean government desires to use the current FDI trends for Korea's development. To make the shift to a knowledge-based innovation-driven economy, more effort will be needed to attract FDI in key strategic industries such as IT, biotechnology, automotive parts, logistics, tourism, and R&D centers. I believe that these discussions showed the way APEC member economies should go, including Korea. I hope next year's APEC/OECD Seminar in Vietnam will be just as successful as this year was.

Here at the Busan Metropolitan City Government Office, the first WAIPA Asia Pacific regional conference is being held, bringing together FDI promotion agencies, businesses, and international organizations from APEC member economies and the world. Moreover, the APEC Investment Opportunities 2005 will kick off tomorrow with the opening ceremony and investment presentations by member economies. I ask for your support and participation in this regard. In closing, I thank the OECD, APEC, and KIEP for making today's meeting possible. Thank you for being here. Thank you.

# Closing Remarks

***Mats Isaksson***
Head
Corporate Affairs Division, OECD

Mr. Chair. Ladies and gentlemen, distinguished panelists. We have experienced a seminar full of insights and in terms of substance we've had an impressive range of experts, policy makers, and commentators during this 1 and a half days. But what I think, when I walk away with sincerity, in which I find really impressive as well, is the rapid progress in consolidating and advancing the cooperation between the OECD and APEC in this field. And the contacts that have been made among the participants in this room over this one and a half days across these two organizations. This is after all only the second step so to speak after Chile, in developing this cooperation. But it walks with long legs, just as long as mine almost making headway in this important cooperation. And I think that is pretty unique and very promising in terms of international cooperation, which is often very complicated process to advance. This is straightforward and we have seen already that there is plenty of tangible suggestions for how to advance the work. I think that Roy laid it out in his presentation very well providing not only a comprehensive I think set of options but he also laid out what is possible to do it, and why is it possible to do it and why should it be done together? Rather than separately. It was a very solid analysis and I from our part there are a couple of points that I would like to that I take home at least. It seems from the not only from Roy's presentation but also from other interventions that the PFI as of being developed at the moment seems to be a natural platform for at least some of the corporations that we see ahead of us regardless of the exact character of the corporation. It's an instrument I believe where a lot of different activities on which a lot of different activities can be based be they self-assessments, be they peer reviews of individual countries.

I also think that the OECD can bring analysis to the party in the form of the database we are presently developing and Marie-France gave you a short preview of the kind of analysis and the information that will come out of this work. And I think that will give us quite a solid basis actually for where we can retrieve information and pursue further analysis. It's been mentioned, and I think it was Mr. Bowman who mentioned the almost in the sense of envy that the OECD has a regular secretariat that there are some 18,000 staff members in Paris that are dedicated to empirical and analytical research. This is indeed a great asset in the organization. And here I need to be careful with my words because I'm going to say something that is diplomatically very complicated. But I believe in it and the secretariat of the OECD believes in it. And that is that the real asset, the underlying asset of the OECD is the committee structure. The committees that meet on a regular basis policies from capitals of OECD countries with policy makers coming to OECD on a regular basis to share their experience and advice the secretariat actually on what kind of work to undertake. Mr. Steffens here is obviously the representative of Germany in the investment committee and I think as this work goes along, we will involve a more of your colleagues in this communication and also to experiences and conclusions from this event back to the investment committee for their information. With those words on behalf of the OECD, I would like to thank your participance to all the experts and all the policy makers that have been attending the meeting. I would like to extend a special thank of course to our counterparts in APEC. And to the host, the ministry of commerce industry and energy, particularly to Mr. Choi and I hope to see in the future and I wish you a pleasant journey home. Thank you.

# Closing Remarks

***Alan Bowman***
Chair 2004-2005
APEC Committee on Trade and Investment

If you don't mind, I'll do it from here. It'll be much simpler. I'll be very, very brief and thank you very much. I've said I noticed that I'm both an opening speaker and a closing speaker and most of my remarks I've made during the opening speech. So I will not go over those remarks again, you heard those yesterday. So I will simply thank everybody for your participation. I am very on behalf of APEC, I am very, very happy that we had a good turnout and this seminar is launching a week long series of investment events here in Korea. My special thanks go to the ministry of commerce industry and energy, Mr. Choi here but also your colleague here Miss Kwon. I don't know if she's here. Of she's back there. She from the very beginning of the year she came and see me February I think in APEC and said, we want to do a seminar can you help and so, so. I'd like to recognize her own work on this. I think it would not have happened without her. And also thanks to Roy Nixon from APEC, thanks to Marie-France from the OECD but thank you very much to all of you especially for participating and I hope you found this worthwhile. It was certainly interesting for me. As I said in the beginning of my remarks yesterday I'm not an investment expert, I'm more of a trade expert. But in APEC we combine the two, which is leading often to very productive outcomes. So thank you again and hope to see you next year at the same event in Hanoi Vietnam. Thank you.

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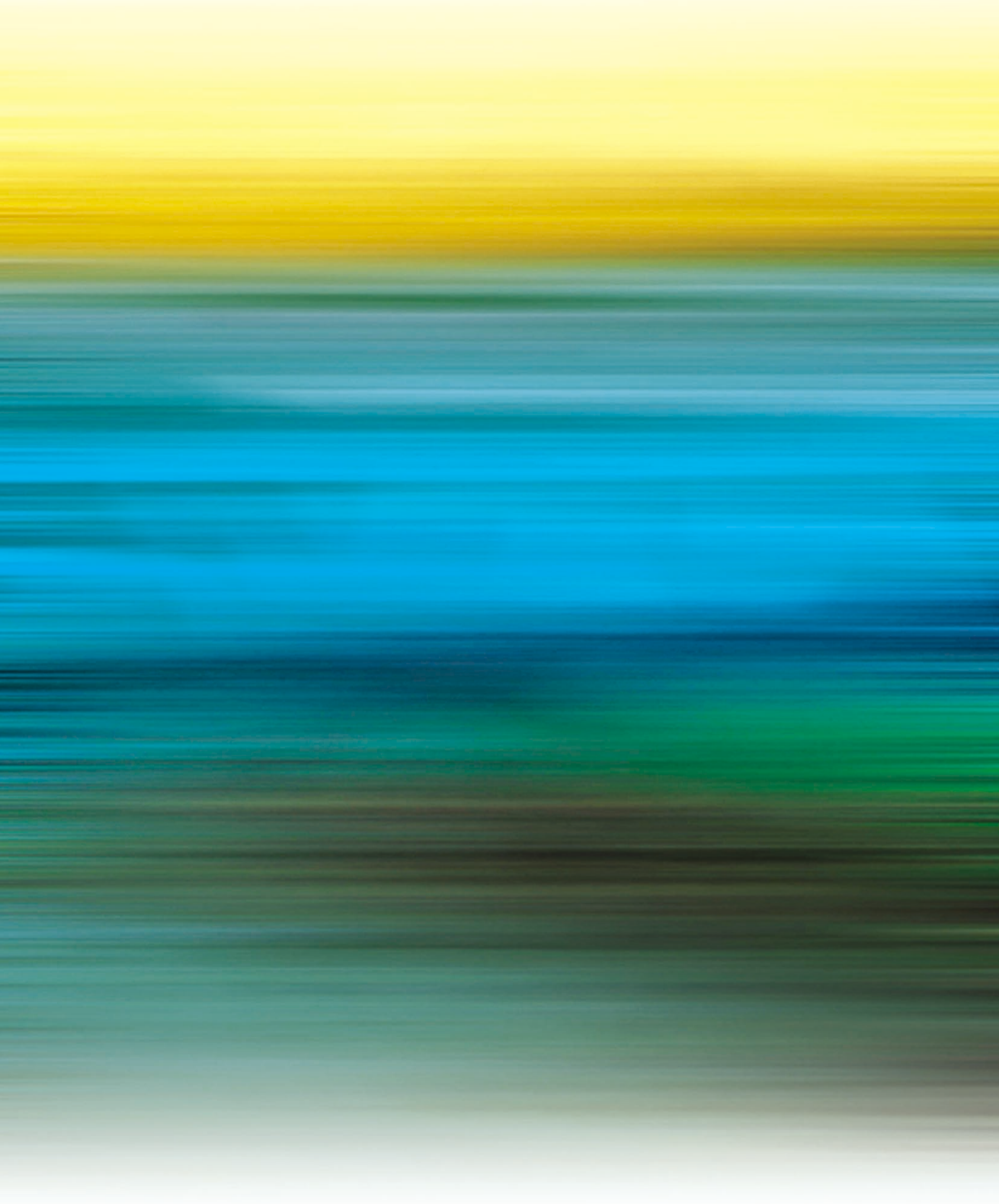

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