EMERGING ECONOMIES TRANSITION

OECD Global Forum
on International Investment

Attracting International Investment for Development

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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The essence of CCNM co-operative programmes with non-members is to make the rich and varied assets of the OECD available beyond its current membership to interested non-members. For example, the OECD's unique co-operative working methods that have been developed over many years; a stock of best practices across all areas of public policy experiences among members; on-going policy dialogue among senior representatives from capitals, reinforced by reciprocal peer pressure; and the capacity to address interdisciplinary issues. All of this is supported by a rich historical database and strong analytical capacity within the Secretariat. Likewise, member countries benefit from the exchange of experience with experts and officials from non-member economies.

The CCNM's programmes cover the major policy areas of OECD expertise that are of mutual interest to non-members. These include: economic monitoring, statistics, structural adjustment through sectoral policies, trade policy, international investment, financial sector reform, international taxation, environment, agriculture, labour market, education and social policy, as well as innovation and technological policy development.

FOREWORD

The boom in capital flows to emerging markets is over, but foreign direct investment has held up well, despite declining in absolute terms over the past two years. In virtually every region, FDI has become a driving force of economic development. Many countries have liberalised their FDI regimes and are pursuing domestic policies to maximise the benefits of foreign presence in their economies.

The recent international summit declarations, *i.e.* the Doha Development Agenda, the Monterrey Consensus, the New Partnership for Africa's Development, the OECD Ministerial and the Johannesburg World Summit, all underscore the importance of international investment as a priority area for further analysis and capacity building in achieving sustainable development goals and ensuring that poor countries are not left behind.

This volume is a collection of conference papers from the OECD Global Forum on International Investment (GFII) held in Shanghai on 5-6 December 2002. It covers, *inter alia,* a wide range of such current investment issues as the developmental impact of FDI, good corporate citizenship, investment incentives, linkages between FDI and local enterprise development, complementaries between FDI and portfolio investment, synergies with official development aid, and responsibilities of home countries in building capacities.

It is the third in a series of proceedings of the Global Forum on International Investment and is published on the responsibility of the Secretary-General.

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Mehmet Ögütçü, manager of the OECD GFII, assembled the publication and co-edited it with Prof. V.N.Balasubramanyam of Lancaster University. France Benois, Jennifer MacGillivray, Edward Smiley and Alexandra de Miramon contributed to the preparation of the publication.

The GFII serves as an open and inclusive forum for dialogue on emerging issues among the international investment policy community and other main stakeholders. It provides a platform for exchanging best practices and exploring new ways of approaching the challenges and opportunities created by FDI.

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INTRODUCTION

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Attitudes towards the role of foreign direct investment (FDI) in the development process have changed significantly in recent years. Early debates during the decades of the sixties and the seventies were marked by advocacy and opposition to FDI often ranged to extremes. Now the talk is not about exploitation of developing countries by the multinationals, the major purveyors of FDI, nor is it about its prowess in efficiently allocating resources on a global scale and integrating the world economy.

The discussion is now about seeking ways and means of maximising its benefits to the host countries and minimising its costs. It is now a recognised fact that whilst FDI may not be an initiator of development it is a superb catalyst in the development process. The challenge to policy makers is how best to provide the business environment and the co-operant factors that not only attract FDI but also maximise its benefits. We owe this dramatic change in attitudes to a number of factors including the decline in bank credit following the debt crisis and stagnant if not declining aid flows. The recognition of the potential contribution of FDI to development is though not entirely driven by the decline in alternative sources of capital, but more importantly by the proven ability of FDI to transmit technology and know-how including managerial and marketing know-how across borders.

The theme of the conference, at which the papers in this volume were presented, – "Attracting FDI for Development" aptly captures these altered attitudes and perceptions of policy makers and commentators on FDI. For the reasons cited earlier, competition for FDI amongst developing countries has increased in recent years. They appear to vie with each other in offering various sorts of fiscal incentives and subsidies to attract FDI. It is by now almost the received wisdom that such sweeteners may be futile in the absence of the sort of distortion free business environment and co-operant factors in the form of threshold levels of human capital and infrastructure facilities foreign investors seek. How best to create and promote such an environment? How can the least developed countries, which now attract negligible amounts of FDI, stake a claim to a share of FDI, which enables them to stimulate development?

It is also apt that the theme of the conference emphasises the role of FDI in development, a much broader phenomenon than growth, encompassing employment opportunities, promotion of skill formation and reduction in income inequalities and poverty. The organisers of the conference couldn't have chosen a better venue for their deliberations than the historic city of Shanghai in China. This last year China attracted in excess of $50 billion of FDI, which puts her atop the league table of recipients of FDI, which includes both the developing countries and the developed countries. China's extraordinary success in attracting FDI has received widespread attention and she is now regarded as a role model for other developing countries aspiring for increased flows of FDI.

The papers in this volume elaborate analyse and discuss in detail the theme of the conference. They do so from various perspectives- that of policy makers, academics, those in charge of monitoring and analysing FDI in the international organisations such as the UNIDO, the WTO and the OECD and representatives from the Civil Society. Their contributions provide a varied menu of topics relating to FDI, rich in analysis and suggestions for policy formulation.

It is impossible to do justice to the rich variety of issues raised in the 21 papers in the volume in this brief introduction. The two papers in the first section of the volume set the scene for the rest of the papers in the volume. Whilst Richard Hecklinger's opening remarks raises several issues relating to host and home country policies, his reference to the responsibilities of the foreign investors in promoting development objectives of the host countries and the need for appropriate policies on the part of the home countries of the investors is timely and perceptive. So too is the discussion of China's broad policy framework by Ms. Ma Xiuhong, Deputy Minister in China's Ministry of Foreign Trade and Economic cooperation.

The issues raised in the scene setting papers are analysed in detail in the set of papers on ways and means of harnessing FDI to development objectives. Hans Christiansen and Mehmet Ögütçü's paper, drawing upon a wide-ranging report by the OECD on FDI for Development, raises a number of issues for policy. One significant policy oriented issue they allude to relates to host country policies, which target FDI specifically for either import substitution, or export promotion through the establishment of the ubiquitous export processing zones in many developing countries. Their suggestion that such policies are of dubious value is worth pondering.

Indeed, it is now the received wisdom that a neutral policy which emphasises neither import substitution nor export promotion, but leaves allocation of resources to market forces attracts a relatively large volume of FDI than a targeted approach grounded in artificial policy initiatives such as export subsidies and tariffs on imports. Their plea that the home countries of foreign investors for their part should eliminate trade barriers and facilitate trade generated by FDI deserves recognition by policy makers in the home countries of investors.

Yet another issue, which requires much, more recognition than it has received, is the impact of FDI on the rights of labour and labour relations. Rajasekaran's paper in this section of this volume provides a critical appraisal of labour relations in the context of globalisation. His comment that respect for freedom of association (meaning right to unionise) is central to the attainment of economic development and sustainable growth is most perceptive. And few would disagree with him when he says "higher wages act as a spur to productivity improvements by obliging employers to try harder to make economies on other elements of their costs, so increasing the efficiency of the production process".

The four papers in the section on "Maximising development benefits; linkages with local enterprises and supply chain management" address the issue central to FDI and development. It is how best to maximise linkages between foreign firms and the local economy. Put differently, in the economist's parlance –how best to maximise spillovers and externalities arising from FDI. The set of papers in this section provide much food for thought for both policy makers and the companies engaged in FDI. Central to all of the papers in this section is the emphasis on corporate responsibility, transparency of rules and regulations and reduction of uncertainty in the environment for business. Whilst France Benois' synthesis of the discussion provides an excellent overview of the discussion on the set of papers, it is worth citing here an unusual and effective strategy initiated by the Brotherhood of St. Laurence, an Australian non-government welfare organisation, which produces and imports optical frames from China into Australia. The paper on the work of the Brotherhood in China by Serena Lillywhite should be read for the light it throws on targeted initiatives to promote effective supply chains can achieve. The company devoted two years worth of its profits to fund a thorough investigation of the supply chain, the conditions of work in the company in China and measures to improve working conditions. The paper highlights the valuable lessons from the initiative and its conclusion that direct engagement with suppliers and the promotion of education and training is the most meaningful way to enhance the effectiveness of supply chains, is a most valuable lesson for investors and policy makers alike.

One of the problems highlighted in many of the papers and the discussion in the conference is the relatively low volume of FDI in the least developed countries. The problem here is the relatively poor infrastructure facilities in these countries, low endowments of human capital and the absence of effective corporate structures and meaningful macro economic policies, all of which are essential ingredients for successful utilisation of FDI in the development process. The set of papers in section V of the volume explore alternatives to FDI and ways and means of forging complementarities between FDI and other forms of capital flows. Here again the synthesis provided by Ken Davies admirably summarises the issues. Are there effective mechanisms which can enable these countries to attract increased flows of FDI?

One suggestion which has surfaced fairly frequently in the literature is to link FDI with other forms of capital flows, principally foreign aid. The paper by Vangelis Vitalis of the OECD besides providing a succinct review of recent trends in FDI and aid flows to developing countries, explores in detail the synergies embedded in FDI and aid flows. Public aid can be targeted to improving not only infrastructure facilities of significance to private foreign investors but it can also be used to influence host countries to improve their macroeconomic policy framework and institute effective governance. All of these can promote domestic savings which can complement FDI and beyond that they can create the sort of business environment which foreign investors seek. This paper provides much food for thought for aid agencies and policy makers in developing countries.

The currency crises in some of the Latin American countries and the east Asian financial crisis most countries appear to have roused suspicion and distrust of portfolio capital flows in most developing countries and they seem to regard liberalisation of the capital account of the balance of payments as a hazardous move to be approached with considerable caution. Jan Schuijer’s paper in this section of the volume provides an analytical review of the factors responsible for the various currency crises and goes some distance in allaying the fears of host countries concerning capital account liberalisation. The paper by Kimberley Evans in this section of the volume neatly complements Schuijer’s paper with an analytical review of the differing motivation and structure of FDI and portfolio capital flows and suggests that much of the fears surrounding portfolio capital flows may be misplaced and emphasises the crucial role of both sorts of capital flows in the development process.

The final section of the volume brings together a set of papers which address policy issues and policy initiatives relating to FDI in specific countries. They provide a fairly detailed account of the framework of policies and its evolution over time in Thailand, Tanzania, India and Chile. Especially instructive in this context is the paper on Chile’s FDI policy by Karen Poniachik. This carefully crafted paper, besides providing a succinct account of the trends and structure of FDI in Chile, offers valuable lessons from Chile’s policy initiatives to other developing countries. In fact, it provides substantial statistical and factual support to one central issue which emerges in most of the other papers in the volume. It is that sound fundamentals rather than direct incentives are the key to attracting FDI. The sound fundamentals the paper refers to are macroeconomic environment, international integration, institutions and governance and social cohesion and infrastructure. The other message of the paper that direct incentives in the form of tax concessions and subsidies to foreign firms offered to attract FDI may be futile and even detrimental to the objectives of the host countries, has often been rehearsed but rarely heeded to by host countries.

In sum, the papers in this volume offer a rich and varied menu. They cover a wide terrain and offer invaluable lessons for policy makers in both the home and host countries of foreign investors. Many of the issues discussed in these essays have a bearing on wider issues relating to FDI at debate including the case for a multilateral compact on FDI under the aegis of the WTO. This volume, which appears on the eve of the Cancun Ministerial meeting of the WTO, should serve to inform and indeed provoke all those concerned with the role of FDI in the development process.

Part I

THE SETTING

MAKING FOREIGN DIRECT INVESTMENT WORK FOR DEVELOPMENT

Richard E. Hecklinger
Deputy Secretary-General, Organisation for Economic Co-operation and Development

Introduction

Since its inception forty years ago, the OECD has been at the forefront in promoting foreign direct investment (FDI), as well as investment generally, as the means for countries to achieve economic growth and improve the standard of living of their citizens. The OECD has encouraged the adoption by governments of transparent and non-discriminatory policies, of liberal trade regimes and sound competition and tax policies, and of systems, which encourage innovation and entrepreneurship, and optimum development of human capital. The OECD has also made important contributions to the strengthening of corporate governance and corporate responsibility. This OECD Forum was established to provide an open platform to discuss global investment issues and policy challenges facing governments, business, labour and societies as a whole. We are very pleased that all of you have been able to join us for these discussions over next two days.

The theme of this conference – *Attracting FDI for Development* – is most appropriate and timely.

The Doha Development Agenda, the Monterrey Consensus, the New Partnership for Africa's Development, the 2002 OECD Ministerial and the Johannesburg World Summit all underscored the importance of international investment in achieving sustainable development goals and ensuring that globalisation works for all countries, poor as well as rich. They called for further policy dialogue and international assistance to build the capacity of nations to attract FDI and reap its full benefits.

It is no coincidence that this conference is taking place in China**.** China is expected to be the largest recipient of FDI this year, amounting to more than $50 billion. We can all learn from China's on-going efforts to establish an effective, rules-based framework in order to respond to the challenge of mobilising high-quality foreign direct investment. I am pleased that MOFTEC is actively co-operating with the OECD on the development of a major report on China's FDI evolving framework. In this regard, I am also pleased to note that the efforts and policies of Asian governments in general will be the subject of a meeting tomorrow afternoon which will consider the launching of an OECD-Asia investment dialogue.

Making FDI work for Development

A recent OECD report has looked in great depth into the question "Is FDI working for development?" The results of this study will be presented by the OECD Secretariat in some detail this morning, but what is clear is that the benefits of FDI are significant and far outweigh any costs.

However, the benefits of foreign direct investment do not accrue automatically. Nor do they apply evenly across countries, sectors and local communities. The OECD report shows that policies of developing countries themselves determine their ability to reap fully the benefits of FDI.

What policies are we talking about?

Host country policies

Host countries have to provide a stable macroeconomic environment, ensure an effective and non-discriminatory regulatory framework for investment, and upgrade infrastructure and education in order to realise the full benefits of foreign corporate presence.

Investors are selective in their choice of locales for investment. In most investment surveys, host country transparency and the rule of law are listed among the top concerns of foreign investors. These include stepping up efforts against corruption and enhancing policies regarding competition, financial reporting and intellectual property protection to foster a dynamic and well-functioning business sector.

Transparency is an overarching principle of good investment policy. Public sector transparency is important not only for investors, but also for effective public governance and economic and social development. Implementing reforms to improve transparency can be a difficult task. The OECD is currently looking at the broader governance requirements for making transparency a reality as well as ways in which the investment policy community can assist in this process.

While there is a consistent body of policies and best practices which will attract investment, each country faces a unique situation and set of challenges. We are therefore gratified that this conference will discuss country experiences as diverse as those of Thailand, Chile, Brazil, Tanzania and India in attracting FDI for development. Our discussion will also consider the role of tax and other special incentives in the “competition for FDI”. We will look at what have been national and regional experiences with regard to competition for FDI and which factors need to be taken into account in assessing the usefulness of FDI incentives for development.

Another important issue for consideration is the policies of the “home countries” of investors. More than 90 per cent of FDI flows originate from companies based in OECD countries. These countries can also do much to enhance investment in developing countries.

Firstly they can facilitate the access of developing countries to international markets and technology. They can develop synergies between development co-operation and investment through ODA and FDI linkages – an issue which you will be discussing in Session 3 tomorrow. They can encourage non-OECD countries to integrate further into rules-based international frameworks for investment, including adherence to the principles embodied in the OECD Declaration on International Investment and Multinational Enterprises.

OECD countries can also share with non-members the peer review approach to building investment policy capacity. OECD Members have long taken advantage of this approach, and now the seven non-member countries which have adhered to the OECD Declaration on International Investment and Multinational Enterprises are taking part in this peer review process.

What about the responsibilities of foreign investors?

Multinational enterprises can contribute to local enterprise, human capital and environmental development and increased diffusion of technology and other knowledge transfers. This can be done directly and through responsible supply chain management. An important question in this regard is how far can MNEs go in improving their standards of supply chain management? What can reasonably be expected of companies that have production sites in regions with ineffective regulatory and legal frameworks? What management tools, audit and other external services are available to help companies achieve appropriate standards? Where does corporate responsibility end and the responsibility of governments begin? I am pleased to note that session 2 of the conference will address these as well as other important issues.

The OECD Guidelines for Multinational Enterprises can assist governments, enterprises and stakeholders in coming to grasp with these issues. These Guidelines are part of the OECD Declaration on International Investment. While voluntary, the guidelines have been endorsed to date by 37 (OECD and non-OECD) governments, which have made a binding commitment to promote them. The Guidelines are backed up by unique follow-up mechanisms (the National Contact Points) and provide an institutional home for co-operation among governments, business, trade unions and NGOs. Since the Guidelines were strengthened in 2000, their practical value has grown, as evidenced by their use in a number of developing countries.

FDI and Other Capital Flows

The new financial landscape and changing modes of foreign corporate presence make the distinction between FDI and portfolio investment increasingly difficult in practice. Furthermore, these factors also tend to increase the complementarity between FDI and other capital account operations as investors expect to optimise cash management and hedging operations in conjunction with their investments.

A new OECD study “Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements”, describes how and at what pace OECD Members eliminated exchange and capital controls. The study shows that in OECD countries, the removal of capital controls contributed to fostering FDI while, in turn, FDI improved the stability of the balance of payments and the robustness of the domestic financial sector. The issue of how to make FDI and other capital flows mutually supportive for development will be considered in the last session of this conference.

Need for Stronger Partnership

In conclusion, we need to forge stronger partnerships between governments, businesses, multilateral organisations and civil society in order to translate good intentions into tangible actions. For its part, the OECD is committed to working closely with non-members and partners to share experience through dialogue to enhance the role of international investment as a catalyst for development and for greater integration of all countries into the global economy.

CHINA'S FOREIGN INVESTMENT POLICIES SINCE ITS ACCESSION TO THE WTO

Ma Xiuhong
Vice Minister of Foreign Trade and Economic Co-operation of China

Introduction

The OECD, an international organisation known for its studies on policy issues and co-ordination of policies, can boast of experts and scholars in every field and benefits from the experience of its members. Over the years, the OECD has established sound contacts and co-operation with China in the field of foreign investment. China's reform and opening-up requires us to learn from other countries. We are, therefore, willing to further strengthen our policy-related dialogue and co-operation with the OECD. I believe that this forum will deepen the OECD members' understanding of China's investment environment and its corresponding policies and play a positive role in furthering future exchanges and co-operation.

The timing and location of the Global Forum on International Investment (GFII) is apt. Since China became a formal member of the World Trade Organization in December 2001, the Chinese government has fulfilled its commitments. The markets are more open and the administration is transparent and fair. Several multinationals and large numbers of medium and small investors have come to China, and foreign investment has grown substantially in China.

China's economic performance

Let me give you a brief overview of China's economic performance this year and China's policies on foreign investment after the accession to the WTO.

The Chinese government will continue the policy of expanding domestic demand, carry through all the reforms in a positive and prudent manner, quicken the pace of economic restructuring and further expand the reform and opening-up, which has effectively spurred the sustained, rapid and healthy development of national economy and continuously improved the quality of the economy. Imports and exports and the absorption of foreign investment have all played an increasingly significant role in the growth of the economy.

From January to September of 2002, China's GDP grew by 7.9%, investment in fixed assets grew 21.8% compared with the same period last year, sales of consumer goods was up by 10.2%. Imports and exports totalled US$445.14 billion, up by 18.3% compared with the same period last year; imports reached US$212.57 billion, up by 17.2%, and exports US$232.057 billion, up 19.4%. By the end of September 2002, foreign exchange reserves reached US$258.6 billion, increasing by US$46.5 billion compared with the beginning of this year.

Growth in FDI flows

Against the backdrop of the slowdown of the world economy and a sharp decrease in international direct investment, the amount of FDI in China has increased significantly. Foreign investment has increased by a large margin from January to October with 27,630 foreign-invested enterprises newly established, up 34.46%, with the contractual foreign investment to the amount of US$74.989 billion, up 35.85% and the actual investment US$44.721 billion, up 20.05%. By the end of October 2002, the Chinese Government has altogether approved the establishment of 417,655 foreign-invested enterprises, with the actual foreign investment US$439.944 billion. China has received the largest amount of foreign investment for 9 consecutive years among developing countries.

The OECD countries are the major source of China's foreign investment. Among the top 10 foreign investing countries in China, six countries (namely, the United States, Japan, South Korea, the United Kingdom, Germany and France) are the OECD members, which have taken 25.54%, a large share of China's total foreign investment. For the first 10 months of 2002, the OECD countries have newly established 10,517 enterprises in China, with the contractual foreign investment of US$23.647 billion and actual investment of US$15.374 billion, respectively up by 33.21%, 21.01% and 19.77%.

On 11 December 2001, China became a formal member of the WTO, which marked a new phase in China's opening-up. The opening-up will be achieved all round, shifting away from partial opening-up in a limited number of areas and scope; the policy-based opening up featuring pilot projects will give way to predictable opening under the legal framework; the opening-up in the form of voluntary unilateral actions will be replaced by bilateral negotiations with the WTO members. The Chinese government will follow the WTO's rules to step up its efforts to reform foreign-related economic administration systems, further expand the areas of opening-up so as to create a better environment and offer more opportunities for foreign investors to enter the Chinese market.

In order to adapt to the new situation of China's entry into the WTO, the relevant Chinese authorities have, over the past two years, comprehensively reviewed current laws, rules and regulations on foreign investment and formed unified and transparent laws and regulations on the economic and trade administration, which are in line with WTO rules. While screening and modifying the current laws, rules and regulations, the Chinese government has attached special importance to maintaining the stability, continuity, predictability and practicality of the laws on foreign investment. This is important to ensure the growth of foreign investment in China.

Changes in FDI legal framework

Let me outline the recent modifications of China's foreign investment laws and regulations.

1. In order to adapt to the strategic national economic restructuring and the new situation of China's accession to the WTO, the newly modified *Regulations Guiding the Direction of Foreign Investment* and *Industrial Catalogue Guiding Foreign Investment* has been enforced since 1 April, 2002. The new industrial policies and Catalogues have emphasised positive, reasonable and effective utilisation of foreign investment, which are put into four categories: encouraged, permitted, restricted and banned. Compared with the old one, the new Catalogue has made China more open to foreign investment. The entries under the open category have increased from 186 to 262 in number while those under the restricted category have been reduced from 112 to 75. The foreign invested projects under the open category enjoy preferential treatment of exemption from the duties on imported equipments and the value-

added duties on import linkage. The restrictions on equity holding by foreign investors are relaxed.[1]

2. A series of laws and regulations has been drawn up and published, which governs the establishment of start-up investors by foreign invested companies, the public listing in the A stock and B stock markets by foreign invested companies within the territory of China, acquiring the non-circulation share of domestically listed companies by foreign invested companies, the participation of foreign invested companies in the reorganization and treatment of the assets of financial assets management companies, mergers between foreign invested companies and domestic companies, expansion of foreign investors' trading rights.

3. The laws and regulations on foreign investment in the field of trade in services are improving. The relevant laws and regulations have been modified or published, which include talent-matching institutions for foreign investment, telecommunications, civil aviation, road transport, cinemas, distribution of audio and video products, engineering design institutions, printing, architecture and travel agencies. The laws and regulations in the fields of foreign invested companies, foreign trading companies and accounting will be gradually improved.

4. The efforts to protect intellectual property rights are stepped up. In accordance with the TRIPs Agreement, China has modified its domestic laws and regulations such as Copyright Law, Trademark Law and Patent Law, conducted comprehensively bilateral exchanges and co-operation with other countries, who have concerns over intellectual property rights, strengthened legal enforcement and has made positive progress in severely cracking down on and punishing the violation of intellectual property rights.

China's accession to the World Trade Organization has brought about new opportunities for China to attract and better utilise foreign investment. The Chinese government will leverage its WTO membership to optimise its foreign investment environment, improve its people's quality and constantly increase its international competitiveness. The recent focus of our work has been on improving the legal and policy climates for foreign investment, safeguarding the uniformity and consistency of foreign investment related laws and regulations, increasing transparency, pushing forward administration by rule of law nationwide, maintaining and improving a fair and open market environment, discontinuing unauthorised charges, inspection, penalties imposed on foreign invested companies, dismantling protectionism and industrial monopolies, strengthening legal efforts in protecting intellectual property rights, persistently combating infringement and piracy, creating a unified and open market order with fair competition, striving for a sound administrative environment, accelerating the transformation of government functions, promoting rule of law, streamlining approval procedures for contracts and statutes by adhering to such principles as rationality, effectiveness, openness and responsibility, further opening the service sector all-round in a positive, steady and

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1. More areas are open to investment, including the telecommunications, combustion gas, heating power, pipes and networks for urban sewage, which are listed for the first time as the areas open to the world. In accordance with the requirements and schedule, to which we have made WTO commitments, on the locality, quantity, business scope and equity holding, the fields of services trade such as banking, insurance, business, foreign trade, tourism, telecommunications, transport, accounting, auditing and legal services are further opened up to foreign investors. At the same time, the relevant commitments are annexed. Foreign investment in western China is encouraged through relaxing the equity-holding and industrial restrictions on foreign investment in the West. The market mechanism of competition is utilised.

orderly manner, improving laws and regulations governing trade in services, and working toward a unified, standardised and open system on foreign investors' market access to the service sector.

Conclusion

The Chinese government will formulate related policies to further encourage foreign investment in new and high-tech, elementary and complementary industries, logistics, delivery, chain-store operations, establishing export-oriented purchasing and product delivery centres, and introducing modern operational concepts, advanced management expertise, technical measures and modern mode of market operation of foreign service sectors. Foreign investors are also encouraged to build infrastructure, explore mineral and tourist resources, and protect the ecological environment, process farm and husbandry products and other scientific projects in the middle and western regions.

The government will create conditions to promote re-investment by foreign invested companies along the coastline in the middle and western regions, encourage foreign investors to participate in the west-to-east gas diversion project, west-to-east electric power transfer project and other complementary projects, encourage multinationals to set up headquarters, R&D centres, and export-oriented purchasing centres in China, encourage small and medium-sized enterprises to join and co-operate with one another, and encourage foreign investors to participate in the restructuring and reshuffling of SOEs.

Part II

HARNESSING FDI TO DEVELOPMENT OBJECTIVES

OVERALL CONFERENCE SYNTHESIS REPORT

Mehmet Ögütçü, OECD

The third GFII on "Attracting Foreign Direct Investment for Development" held in Shanghai was hosted by China's Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and the Municipal People's Government of Shanghai. Back-to-back with the GFII the Secretariat organised the OECD-China Steering Group meeting, where the preliminary findings of the OECD study of China's FDI policies were discussed, and the OECD-Emerging Asia Exploratory Meeting, discussed the immediate areas of interest for policy dialogue on investment issues.

The more than 160 participants to the GFII included investment officials from eighteen OECD countries, twenty-eight non-members from Tanzania to Russia, from Brazil to Saudi Arabia as well as representatives of China's central government and provincial governments, business executives, multilateral organisations (i.e. Asian Development Bank, European Commission, United Nations Industrial Development Organisation, World Association of Investment Promotion Agencies, Black Sea Economic Co-operation, Commonwealth Secretariat), civil society partners such as India's Consumer Unity & Trust Society, Malaysian Trade Unions Confederation, Brotherhood of Saint Lawrence.

More than 20 papers were presented or tabled. The conference was extensively covered by China Central Television, national China Daily, local Shanghai press, Financial Times FDI Magazine, Economist Intelligence Unit, Far Eastern Economic Review, which carried interviews with OECD staff and conference speakers.

A brief highlight from the GFII conference presentations and deliberations includes the following:

Session 1

- The boom in capital flows to emerging markets is over, but the boom in FDI is not, though its levels have receded over the past two years. The surge in FDI flows and the decline in aid have transformed the nature and composition of external finance to the developing countries. FDI flows to the developing countries rose from 0.4 per cent of the gross domestic product in the late 1980s to 2.8 per cent in the late 1990s in response to the globalisation of production and improvements in domestic policies. Nowadays FDI is the only net source of financing for the developing world. The share of developing countries in global FDI flows is relatively low compared with domestic investment in these countries, now about $1 trillion.

- In virtually every region, FDI is a driving force of globalization and has risen relative to total capital expenditures during the 1990s. It has doubled in middle-income countries and has tripled in low-income countries. However, recently FDI flows have declined. The decline can be almost wholly attributed to reduced flows into Latin America, as FDI into Central Europe and East Asia have been sustained. This resilience of East Asia as a recipient of FDI underscores the importance of integration into global and neighbouring markets that China [recently gaining membership in the World Trade Organization (WTO)] and Central European countries [anticipating European Union (EU) accession] are following at present.

- In the first session, the presentation of the main findings from OECD's recent report "*FDI for Development: Maximising Benefits, Minimising Costs*" was followed by a discussion of the two significant examples: Thailand, where extensive investment incentives were used to attract FDI, and Chile, where a "beauty contest" was the main strategy deployed for attracting FDI. It was generally agreed that FDI was good for growth because it facilitated technological transfer, international trade integration, a competitive business environment, and encouraged efficient management techniques through the so-called "spill-over" effects. In addition to this, as some speakers underlined, was the "stable" nature of FDI, characterised by relatively low volatility and its longer term duration. These factors should combine to provide an enabling environment, which is propitious for growth.

- It was also argued by one participant that, although investment incentives were a "reality" in many countries, competition for FDI may be diverting resources from other areas of economic and financial endeavour. There were challenges from the floor, particularly to the assertion that FDI generally resulted in improved environmental and social standards, increased domestic investment and exports, reduced imports and enhanced linkages with domestic companies. A trades union representative from South East Asia cited examples of coal mines operated by multinational enterprises, which inflict enormous damage on the environment and of examples where MNEs rely on "cheap" labour. Concern was expressed that in the pursuit for FDI beggar-thy-neighbour policies had been deployed, labour and environmental standards were lowered which resulted in the inevitable race to the bottom. Lack of transparency in the provision of incentives could create opportunities for corruption and rent-seeking, resulting in inefficiencies and market distortions inimical to competition. Replacing incentives-based competition by rules-based means of attracting FDI would reduce these costs.

- The discussion demonstrated that the development value of FDI was clear but has become increasingly more nuanced and complex. FDI cannot be the main source for solving the developmental problems. It is a valuable supplement to domestically-provided fixed capital rather than a primary source of finance. The bulk of FDI inflows continues to go to countries with relatively large markets and reasonably good policies. There was general agreement that FDI could not be allocated like state investment or ODA, but should be competed for and won. Therefore, the motto "policies matter" was widely shared among participants, if FDI's contribution to development were to be maximised. Improving the domestic investment climate, particularly through sound macroeconomic policies and governance, could reduce the volatility of capital flows and attract FDI which is relatively less volatile.

- Business speakers insisted that cost control was not their top priority; they were most interested in access to customers and stable economic/political environment. The most important factor in creating favourable conditions to attract FDI was good governance. If such conditions prevail, no special incentives are needed to attract foreign investment or indeed domestic investment.

- During the discussion about the responsibilities of home countries, the effect of the strong growth in OECD countries on global FDI environment was discussed in addition to market access, technical assistance and capacity building, and promotion of responsible corporate behaviour. The Deputy Secretary General of the OECD Hecklinger stressed that the global economic recovery was fragile because investment spending was insufficient to underpin continuing growth. He noted that one of the important contributions of OECD countries, the main source of FDI, was to stimulate growth in their own countries which would in turn fuel FDI growth as well as greater market access opportunities to developing countries. It also emerged that countries with sound investment climates were experiencing far less volatility than countries with deficient policies and institutions.

Session 2

- A vibrant SME sector is essential for promoting sustained, private sector led economic growth and development and meeting the Millennium Development Goals. To a large extent, private sector development in developing countries means focusing on the SME sector and its linkages with other enterprises. There was a discussion on fostering SMEs' competitiveness (at local and international level), which requires, *inter alia*, (i) helping SMEs to remain competitive in their domestic and regional markets, (ii) helping SMEs to access and compete in international markets; and (iii) creating an enabling environment. The discussion also focused on how to make SMEs better local partners for foreign investors – to make them attractive to FDI and to strengthen the benefits of foreign investment to the local economy.

- The past two decades have seen a striking growth in the international activities of firms of all sizes – not only large multinational enterprises (MNEs) in OECD countries but also in SMEs from OECD and developing countries. However, SMEs often face difficulties linking up with MNEs because of their lack of competitiveness, necessary human skills and globally integrated production and trading systems of MNEs. Experience shows that governments that understand the competition needs and priorities of investors can attract new investments more effectively and root them more deeply in their economies.

- Enhancing donor co-ordination and pooling of technical and financial resources for addressing the capacity gaps and strengthening the competitiveness of the SME sector (with a particular focus on the trade- and investment-related capacity building needs). Donor co-ordination is also an important aspect of improving aid effectiveness and forging effective partnerships.

- Integrating policies aimed at the attraction of FDI with policies for domestic enterprise promotion and capacity building. Business support agencies have a key role in helping domestic business to become geared up to compete internationally and to build partnerships with foreign investors.

Session 3

- This session produced a lively and constructive discussion. The OECD's Code of Liberalisation of Capital Movements, recent capital account liberalisation experiences and how these may be of relevance to other countries were presented. The speakers emphasised that FDI and portfolio forms of cross-border investment are complementary and beneficial to national economies. It was pointed out that the experience of a number of developing countries based on conventional wisdom regarding FDI attraction is not universally applicable and that both FDI attraction and the benefits to be derived from FDI depend on institutional frameworks and policies. There was a discussion of the FDI/portfolio investments flowing to Brazil, the second largest recipient of FDI after China among developing countries. FDI has replaced portfolio investments in its entirety in this country.

- The session concluded with an elaboration of the synergies between ODA and FDI, which attracted much attention. Carefully targeted ODA can be concentrated on nourishing human capital and institutions of good governance, as well as on leveraging FDI flows and creating a virtuous cycle if increasing savings and investment. More specifically, it was also suggested that ODA funds could be used to support those areas considered important to investors in determining investment locations, i.e. public-private partnerships in infrastructure and human capital improvement. Several speakers underlined that developing countries should take the lead in setting up a country-driven investment capacity building framework and that the role of donors was to support and facilitate this process.

GFII 2003 – South Africa

A country's economic performance over time is determined to a great extent by its political, institutional and legal environment. These institutions and policies are referred to as the governance infrastructure of a country. The conference discussions clearly indicated that governance infrastructure was an important determinant of FDI inflows and outflows. Investments in governance infrastructure not only attract capital but also create the conditions under which domestic companies emerge and invest abroad.

The African participants from Ghana and Tanzania called for the next GFII annual event to be held in sub-Saharan Africa to address the governance and transparency issues.

FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT: MAXIMISING BENEFITS, MINIMISING COSTS

Hans Christiansen and Mehmet Ögütçü,
Principal Administrators, OECD Directorate for Financial, Fiscal and Enterprise Affairs

Introduction

The proper question to ask about globalisation is not whether one personally likes or dislikes it. Globalisation is a fact, and the key question is how to manage it as a force for global welfare and development. This poses important policy challenges for all countries, developed, developing and transition economies alike. This is why the Doha Development Agenda, the Monterrey Consensus, the New Partnership for Africa's Development, the 2002 OECD Ministerial and the Johannesburg World Summit have all underscored the importance of international investment as a priority area for further analysis and capacity building in achieving sustainable development goals and ensuring that poor countries are not left behind and benefit from globalisation.

The recent OECD report *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*[1] – a result of extensive work and consultation by the OECD investment policy community represented by the Committee on International Investment and Multinational Enterprises – responds to the international community's reinvigorated efforts to mobilise FDI in support of sustainable development. The report, surveying evidence from around the world of linkages between inward FDI and economic development, addresses a wide number of issues, among which:

– What is the impact of FDI on economic growth?

– What is the link with trade integration?

– How can FDI best contribute to technology diffusion and human capital formation in the host countries?

– Does FDI promote competition, enterprise restructuring and corporate governance?

– How does it affect social and environmental performance of the host countries?

– What are the policy requirements to maximise the benefits and minimise the costs of FDI?

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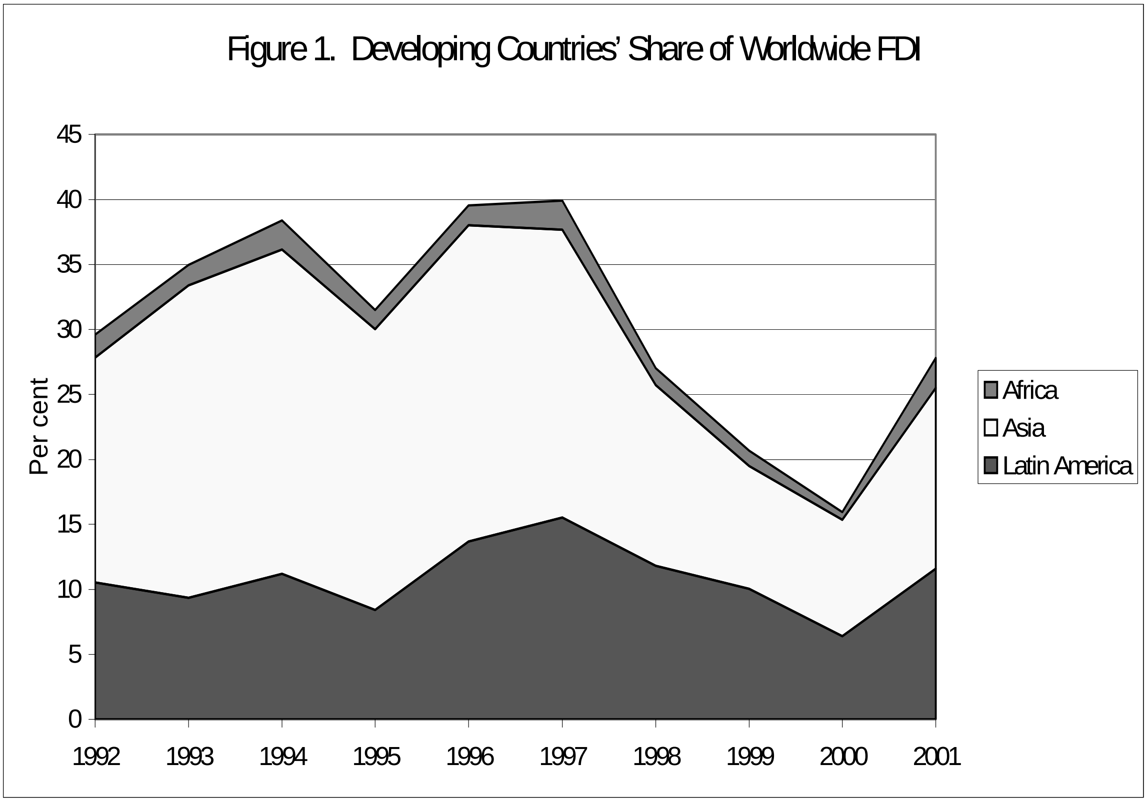
Recent FDI trends

Cross-border investments in the world economy have risen dramatically over the past decades. Between 1973 and 2000 worldwide annual FDI flows increased fifty-fold from $25 billion to $1.271 billion. The share of FDI in GDP (the cumulative GDP of all countries) rose to 17 per cent compared with a mere 6 per cent in 1980. Developing countries, emerging economies and countries in transition increasingly see FDI as a factor of significance (and not a panacea) of economic development. Most countries have liberalised their FDI regimes and pursued other policies to attract investment. They have addressed the issue of how best to pursue domestic policies to maximise the benefits of foreign presence in the domestic economy.

One commonly heard complaint about FDI is that developing countries receive only a small share of global FDI flows (Figure 1).



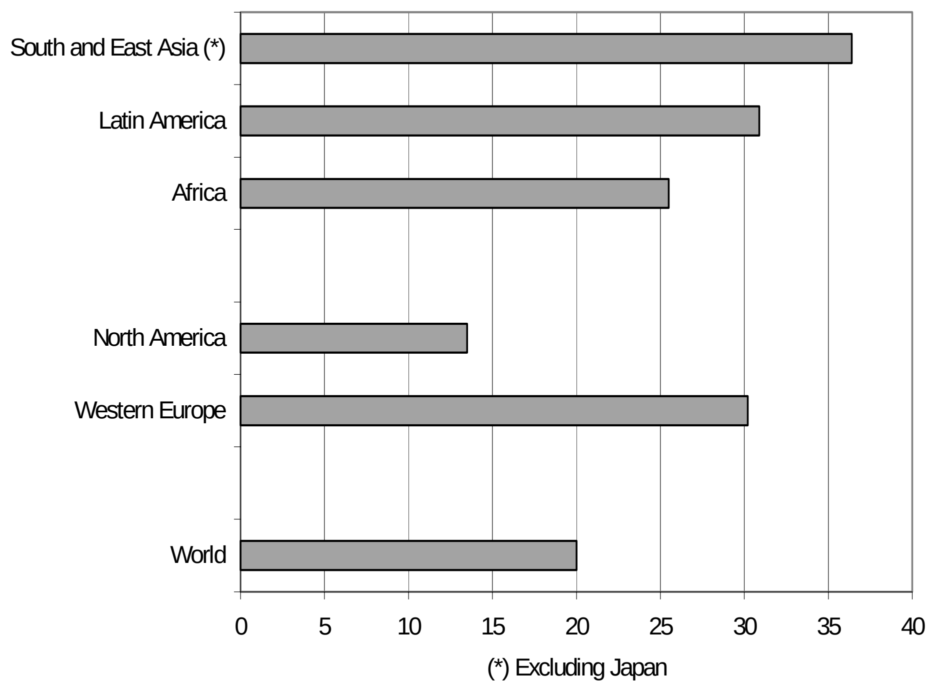
Source: IMF Balance of Payments Statistics

The relatively low share of FDI to relatively poor nations needs to be qualified by a couple of observations. First, the relatively low share of developing country FDI in recent years reflects the "investment bubble" in the rich countries in the late 1990s and year 2000. Developing countries continued to attract FDI during this period. Second, the figure suggests that the present slowdown in FDI – which declined to nearly 50 per cent of the flows between the largest economies in 2001 – could return the share of developing countries to their long-term average of about one third of global direct investment flows.

Doubt is also cast on the beneficial effects of FDI for development by some on the grounds that those funds that do flow to developing economies are concentrated in a few countries.

It is a fact that in 2001, China, Hong Kong, China, Mexico and Brazil received more than half of the $204 billion of FDI that went to developing countries. However, they are also among the largest of developing economies – with the exception of Hong Kong, China together with mainland China. Thus, one can also present things a bit differently. The potential benefits of FDI are perhaps best measured by the extent of foreign corporate presence relative to the size of the host economy (Figure 2).

Figure 2. Inward FDI as a proportion of GDP



Source: UNCTAD

Measured this way, developing South and East Asia are the world's principal recipients of FDI. The ratio of FDI to GDP in the developing countries is well above the world average and that in developed countries such as North America. In other words, on average developing countries are well-placed to reap the benefits of FDI. Still, there could be excessive concentration within the regions.

How does FDI contribute to development?

This report does not limit itself to surveying the *benefits* of FDI. It also analyses possible drawbacks of FDI – the so-called "costs". The economic costs of FDI, where they occur, mostly take the form of unintended side effects of the benefits. Hence, they should not be seen in isolation. The side effects have been found to include the distributional consequences of enterprise restructuring; competition effects where foreign entry results in greater market concentration; and balance of payments volatility in response to the import and export patterns of foreign-owned enterprises. It must, however, be stressed that most such "costs" are generally of a short duration and can be corrected through appropriate host country policy measures.

The report focuses on the overall effect of FDI on macroeconomic growth and other welfare-enhancing processes. It offers an analytic synthesis of all the work that has been undertaken in the area of FDI and development. As such, it draws on studies by OECD, other international organisations and a wide selection of contributions from academics. Investment generally improves a country's economic performance, but FDI carries additional advantages. These manifest themselves through several channels:

FDI and macroeconomic growth

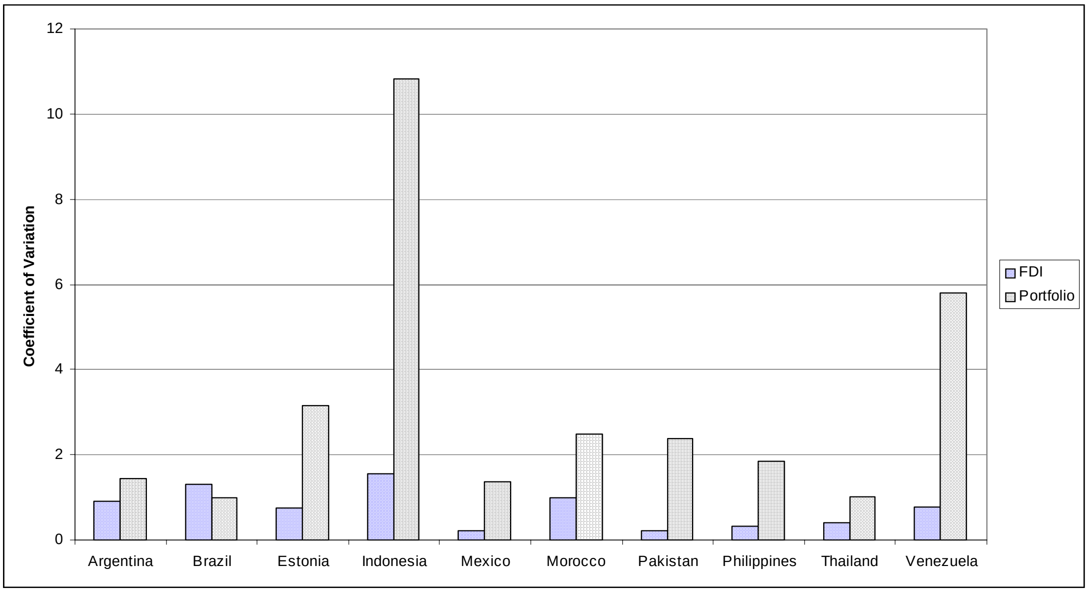
When one undertakes a survey of Foreign Direct Investment for Development, one question immediately springs to mind: Why should investment have to be foreign investment? We all know that investment promotes productivity growth, technological progress, incomes and employment, but what may be the specific advantages of attracting foreign investors? The OECD argues that the advantages are threefold:

First, in some developing countries domestic savings are too low to finance an optimal rate of capital-building. If, at the same time, they have problems accessing international financial markets, FDI may alleviate domestic finance constraints. A similar effect occurs where domestic savings may be ample, but a deficient banking system is unable to funnel the available funds to domestic investors.

Second, FDI is a more stable source of external finance than portfolio investment and borrowed funds. For example, in times of financial crises, loans and short-term securities investment are usually withdrawn very swiftly. Investors with a direct stake in enterprises normally stay put. In other words, direct investors are in for the long haul. This can be shown by a comparison of FDI with portfolio investment in developing countries over the last decade. In all countries except Brazil direct investment flows have displayed significantly less volatility (Figure 3).

Figure 3. Comparing the volatility of FDI and portfolio investment

(1990-2000)



Source: IMF International Financial Statistics.

Finally, and perhaps most importantly, countries at all levels of development benefit from foreign corporate presence in their business sectors. The report identifies three classes of advantages that foreign presence may bring. These are, in fact, the main focus of the report.

FDI and trade integration

As countries develop and approach industrialised-nation status, inward FDI contributes to their further integration into the global economy by generating foreign trade flows.

Here apparently, several factors are at play. They include the development of international networks of related enterprises and the increasing importance of foreign subsidiaries in MNEs' strategies for distribution, sales and marketing. In both cases, this leads to an important policy conclusion, namely that a developing country's ability to attract FDI depends on the investors' subsequent access to importing and exporting. This implies that countries seeking to attract investors should consider a policy of openness to international trade as central in their strategies.

Some countries have attempted to use FDI in a more targeted manner to either boost exports or limit imports. As for the first of these points, FDI may clearly boost exports where inward investment helps host countries that had been financially constrained to make use of their resource endowment or their geographical location. However, the experience with targeted strategies – notably the so-called export-processing zones – has been mixed. Such zones tend to raise imports as well as exports, and it is not clear whether benefits to the domestic economy justify the drawbacks that inevitably occur. The latter include the direct costs of setting up EPZs to the public purse and the risk of creating an uneven playing field between domestic and foreign enterprises.

Policies aimed at using inward investment to bring MNEs "inside the garden gate" and hence substitute for imports have also produced limited benefits. According to recent studies, FDI actually tends to lead to an upsurge in imports, which is gradually reduced as local companies acquire the skills to serve as subcontractors to the MNEs.

FDI and technology transfers

The spillovers (or "positive externalities") generated by FDI fall into two categories, namely technology diffusion and human capital building. FDI brings new technologies into developing countries, which are eventually diffused to the broader domestic business sector. The channels through which this may take place are legion, but the OECD report concludes that the most important source of technology spillovers is "vertical linkages" between MNEs and local suppliers. Foreign-owned enterprises usually provide their suppliers with technical assistance, training and other information to raise the quality of their products. Also, many MNEs assist local suppliers in purchasing raw materials and intermediate goods and in modernising or upgrading production facilities.

However, there appear to be large gaps between importation and the actual use that host countries are able to make of the technologies thus transferred. Crucially, the technologies need to be relevant to the host-country business sector beyond the company that receives them first. In this respect, the general technological level of the host country's business sector is of great importance. Evidence suggests that for FDI to have a positive impact on productivity, the "technology gap" between domestic enterprises and foreign investors must be narrow. Where important differences prevail, or where the absolute technological level in the host country is low, local enterprises are unlikely to be able to absorb foreign technologies transferred via MNEs.

FDI and human capital enhancement

Investment in general education is of the utmost importance in creating an environment in which foreign enterprises wish to invest. Achieving a certain minimum level of education is paramount to a country's ability not only to attract FDI, but also to maximise the human capital spillovers that may arise from foreign enterprise presence. So is the case with technology, where a significant "knowledge gap" is allowed to persist between foreign entry and the rest of the host economy, no significant spillovers are likely to occur.

The direct impact on human capital of FDI derives mainly from the fact that MNEs tend to provide much more training and other upgrading of human capital than domestic enterprises. However, evidence that the human capital thus created spills over to the rest of the host economy is weak. Moreover, it should be kept in mind that the magnitude of MNE-sponsored training is necessarily smaller than that of general education. The beneficial effects of training provided by FDI can supplement, but not replace, a generic increase in skill levels. The presence of MNEs may, however, provide a useful demonstration effect, as the demand for skilled labour by these enterprises provides host-country authorities with an early indication of what skills are in demand.

Human capital levels and spillovers are closely interrelated with technology transfers. Technologically advanced sectors and host countries are more likely to see human capital spillovers and, conversely, economies with a high human capital component lend themselves more easily to technology spillovers. Consequently, efforts to reap the benefits of technology and human capital spillovers could gain effectiveness when policies of technological and educational improvement are undertaken jointly.

FDI and competition

The direct efficiency gains from FDI fall in two main categories: effects on competition and impact on enterprise restructuring and development.

Since the early 1990s a wave of M&As has reshaped the global corporate landscape. At the same time, a surge in the number of strategic alliances has changed the way in which formally independent corporate entities interact. There has also been a wave of privatisations that has attracted considerable FDI (mainly in developing and emerging countries). This adds up to an increasing degree of concentration in national markets, which could have important effects on competition. Furthermore, the effect of FDI on host-country concentration is, if anything, stronger in developing countries than in more mature economies.

On the other hand, foreign entry also has the potential to increase competitive pressures in a previously "cosy" national market. This argument is underpinned by the fact that MNE entry is generally found to raise productivity levels among host-country incumbents (albeit more consistently so in developed than in developing countries). Unsurprisingly, this effect is strongest in markets where there appears to have been little competition prior to the foreign entry.

Foreign market entry may lead to increasing competition, which may lead to the closure of weaker enterprises, which may lead to increasing market concentration, which in turn may lead to decreasing competition. Hence, while it is desirable that efficient entrants be allowed to replace less productive domestic enterprises, policies to safeguard a healthy degree of competition must be in place. The best way of achieving this is by expanding the "relevant market" by increasing the host economy's openness to international trade. In addition, efficiency-enhancing national competition laws and enforcement agencies are needed to minimise the anti-competitive effects of weaker firms exiting the market.

FDI and enterprise development

Foreign-orchestrated take-overs lead to changes in management and corporate governance. MNEs mostly impose their own company policies, internal reporting systems and principles of information disclosure on acquired enterprises (although cases of learning from subsidiaries have also been reported), and a number of foreign managers normally replace existing management. Where foreign corporate practices are superior to the ones prevailing in the host economy this boosts corporate efficiency. However, in some cases country-specific competences are an asset for managers in subsidiaries. Therefore MNEs usually need to strive toward an optimal mix of local and foreign management.

Foreign participation in the privatisation of government-owned enterprises is a case in point. Experience of firms, many of them from the transition economies in East and Central Europe, have been largely positive. Participation by MNEs in privatisations has consistently improved the efficiency of the acquired enterprises. Some political controversies have, however, occurred because the efficiency gains were often associated with sizeable job losses (in the short run, at least). Moreover, it has been argued by some that the beneficial experience with MNE participation in the privatisation process of transition economies could simply reflect the fact that few domestic strategic investors have access to sufficient finance. In those (few) cases where domestic private investors were brought into previously publicly owned enterprises important efficiency gains have also occurred.

The privatisation of utilities is often particularly sensitive, as these enterprises often enjoy monopolistic market power within segments of the local economy. The first-best privatisation strategy recommended by OECD is to link privatisation with an opening of markets to greater competition. But where the privatised entity remains largely unreconstructed prior to privatisation, local authorities often resort to attracting foreign investors by promising them protection from competition for a designated period. In this case there is a heightened need for a strong, independent domestic regulatory regime.

FDI and environmental and social issues

It is important to stress that FDI affects not only the economy of the host country but also corporate presence in many cases may have important effects on social conditions and the foreign environment.

Taking the latter point first, an OECD study concludes that FDI has the potential to greatly benefit the environment in developing countries. However, for this potential to turn into tangible benefits, host country authorities need to pursue adequate environmental policies.

The technologies that are transferred to developing countries in connection with FDI tend to be more modern and environmentally “cleaner” than what is locally available. Moreover, positive spillovers have been observed where local imitation, employment turnover and supply-chain requirements led to more general environmental improvements in the host economy. True, there has been anecdotal evidence of MNEs moving equipment that was deemed environmentally unsuitable in the home country to their affiliates in developing countries, but this does not seem to represent a general trend.

The OECD report also finds little support for the assertion that efforts to attract FDI may lead to "pollution havens" or a "race to the bottom". Apparently, the cost of environmental compliance is so limited – and the cost to a firm's reputation of being seen to try to avoid them is so great – that most MNEs allocate production to developing countries regardless of these countries' environmental regulations. Unsurprisingly, this is particularly the case where investors' home countries are wealthy or are concerned about the environment.

On the other hand, the linkage between FDI and social conditions is not substantiated very well by empirical research. However, such evidence as there is indicates that foreign investment may help reduce poverty. The beneficial effects of FDI on poverty reduction are potentially stronger when FDI is employed as a tool to develop labour-intensive industries – and where it is anchored in the adherence of MNEs to national labour laws and internationally accepted labour standards.

There is also little evidence to show that foreign corporate presence in developing countries leads to a general deterioration of basic social values, such as core labour standards. On the contrary, empirical studies have found a positive relationship between FDI and workers' rights. Low labour standards may, in some cases, even act as a deterrent to FDI, due to investors' concerns about their reputation elsewhere in the world and their fears of social unrest in the host country.

Policies Matter

The OECD report's policy conclusions fall into three categories, namely: recommended policy action by host country authorities, by home countries and by the international business community itself. The benefits do not, however, occur automatically. One of the key conclusions of the report is that FDI tends to compound both the advantages and the disadvantages of a country's business environment. Only enterprises that operate in a generally sound environment (nationally as well as internationally) can bring the full benefits of FDI to bear on the host economy. More specifically:

What should host countries do?

Most of the effort is to be made by policy makers in the host countries. Host country transparency and the rule of law are listed among the top concerns of investors that policies towards attracting FDI must address. Another very important aspect is the size of the host economy, as evidenced by China's success with attracting FDI. Even small countries can boost the size of "their" market by pursuing policies of general openness to trade regulations.

First and foremost, sound policies for attracting FDI and reaping benefits from foreign corporate presence are very similar to policies for mobilising domestic resources. The experience of OECD Members and other countries show that the measures available to host-country authorities fall into three categories. First, there is a need to improve general macroeconomic and institutional frameworks. Second, the creation of a regulatory environment that is conducive to inward FDI is important. Third, infrastructure, technology and human competences should be upgraded to a level where the full potential benefits of foreign corporate presence can be realised.

The first of these points establishes the fact that every aspect of host countries' economic and governance practices influences the investment climate. The overall goal for policy makers must, therefore, be to strive for the greatest possible macroeconomic stability and institutional predictability. More concretely, the following recommendations are widely supported:

– Pursue sound macroeconomic policies geared to sustained high economic growth and employment, price stability and sustainable external accounts.

– Promote medium-term fiscal discipline, efficient and socially just tax systems, and prudent public-sector debt management.

– Strengthen domestic financial systems, in order to make domestic financial resources available to supplement and complement foreign investment.

The report finds, based on several surveys of investor motivation, that the two main factors motivating FDI are: (i) the size of the domestic market and (ii) the transparency of corporate and public governance. As for the latter point, FDI is obviously unlikely unless investors have a reasonable understanding of the environment in which they will be operating. Moreover, a lack of transparency may lead to illicit and other unethical practices. In this context, host-country authorities should undertake the following measures:

– Strengthen their efforts to consolidate the rule of law and good governance. This includes stepping up efforts against corruption and enhancing policy and regulatory frameworks (e.g. as regards competition, financial reporting and intellectual property protection) to foster a dynamic and well-functioning business sector.[1]

– Work toward increased openness to foreign trade, so the domestic enterprise sector can participate fully in the global economy. The successful elimination of global and regional trade barriers makes participating countries more attractive for FDI, owing to the concomitant expansion of the "relevant" market.

– Enshrine the principle of non-discrimination in national legislation and implement procedures to enforce it through all levels of government and public administration. Given the importance of competition for resource allocation and sustained economic growth, it is essential that foreign entrants should be able compete without government prejudice.

To reap the maximum benefits from corporate presence in a national economy, domestic competences, technologies and infrastructure need to be sufficiently well developed. Otherwise nationals are not equipped to take full advantage of the spillovers that foreign-owned enterprises generate.

Host-country authorities should therefore consider undertaking measures to the following effect:

– Put in place, and raise the quality of, relevant physical and technological infrastructure. The presence of such infrastructure is instrumental in attracting MNEs, in allowing national enterprises to integrate the technological spin-offs from foreign-owned enterprises in their production processes, and in facilitating their diffusion through the host economy.

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1. The OECD recently conducted a survey of enterprises investing into Eastern and South Eastern Europe. They were asked to list – apart from the market size – the top ten factors that made them decide on where to locate. No less than seven of these factors have directly or indirectly to do with transparency and the rule of law. Another piece of supporting evidence was provided by a study undertaken for the Asian Development Bank last year. This study made the most ambitious attempt to date at creating an index measuring the quality of institutional governance in 55 developing and developed countries. There is a clear correlation between good governance and the ability to attract FDI.

– Given the importance of basic, widespread education for development, raise the basic level of education of national workforces. The provision of specialised skills beyond basic education should build on existing competences in the host economy, rather than target the short-term or specific needs of individual foreign-owned enterprises.

– Implement internationally agreed standards. Efforts to reduce child labour, eliminate workplace discrimination and remove impediments to collective bargaining are important in their own right. They also serve as tools to upgrade the skills and raise the motivation of the labour force and facilitate linkages with MNEs operating on higher standards.

What should home countries do?

Turning now to the challenges of home countries, the countries in which MNEs are domiciled – and the developed world more generally – need to review the ways in which their national policies affect developing countries.

Further trade liberalisation would contribute to worldwide economic development in its own right. In the FDI context, the trade policies of developed countries gain a further dimension, insofar as an important share of FDI is contingent upon subsequent trade between related enterprises. Trade barriers and subsidies aimed at limiting imports into developed countries currently impose costs on developing countries. The authorities in developed countries could enhance developing countries' ability to attract foreign investment by working to reduce and eventually eliminate these barriers and subsidies.

Home-country governments need to assess the effects that their technology policies may have on the transfer of technologies to the host economy. Authorities can contribute to a positive outcome by encouraging MNEs to consider the technological needs of host countries. The OECD Guidelines for Multinational Enterprises, which adhering countries are committed to promote, stipulate that enterprises should adopt practices that "permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights".

Another area of action relates to improving the synergies between FDI flows and official development assistance. There is evidence to suggest that carefully targeted development assistance may assist in leveraging FDI flows and creating a virtuous circle of increasing savings and investment. Development assistance can be used to buttress or develop institutions and stable policies in developing countries. This helps create a favourable environment for domestic savings, and for domestic and foreign investment and growth.

What should the enterprise sector do?

The private sector (notably foreign investors) plays a vital role in generating economic growth, and contributing to achieving sustainable development goals. Therefore, the way private enterprises behave and are governed is important in maximising the benefits of FDI for economic development. OECD countries have launched several initiatives to promote responsible corporate behaviour. Among these are the OECD Guidelines for Multinational Enterprises.

Along with provisions for national treatment and other elements of the OECD Declaration on International Investment and Multinational Enterprises, voluntary principles and standards for responsible business conduct are provided by the Guidelines for Multinational Enterprises, recommended by 37 OECD and non-OECD governments to MNEs operating in and from their countries. These recommendations can be read as an approach to the Development Agenda now facing the international community in areas such as technology transfer, human capital management practices, transparency and competition. Moreover, companies should refrain from seeking exemptions from national environmental, labour and health standards.

Multinational enterprises have attempted to respond to public concerns by issuing policy statements, or codes of conduct, which set forth their commitments in various areas of business ethics and legal compliance. Management systems have been designed to stimulate compliance with these commitments, and a number of standardised management systems have emerged. Governments, business associations and other stakeholders can use the Guidelines to support these initiatives and enlist a larger number of companies in the search for best development practices.

Co-operation with Non-Member Economies

A frequent misconception about the OECD is that it works only for its Members – the “rich country’s club” syndrome. This is not so. Even if it wants to do so, the OECD cannot afford to concentrate solely on problems that concern only its Members. For example, a review of the Communiqués of the OECD of recent years illustrates the importance they attach to global issues: financial crises, the environment and climate change, electronic commerce, taxation issues, bribery and corruption, competition and anti-trust issues and governance more generally. Such issues cannot be confined to the OECD countries.

The OECD shares its expertise and engages in policy dialogue with more than 70 non-member economies from all corners of the globe. Why? Because the OECD knows that the destinies of its members are closely tied to those of non-members around the world. These co-operative relations cover a broad range of topics of mutual interest tapping into the Organisation’s extensive reservoir of knowledge and experience. Free from the possible constraints of bilateral relations, these contacts aim to further economic integration by making the OECD’s experience available to other countries and enabling the OECD to profit from the insights and perspectives of non-members.

In this context, the OECD is committed to working closely with non-member economies and civil society partners in experience sharing and dialogue to enhance the role of international investment as a catalyst for poverty alleviation in the world as a whole.

CREATING THE ENABLING ENVIRONMENT FOR QUALITY INVESTMENT

Mr. John Lintjer
Vice-President, Finance and Administration, Asian Development Bank

Introduction

Until recently the debate about FDI assumed that there was and would continue to be an unlimited amount of debt and equity capital generated in developed countries that was keen to invest into developing countries because of the promise of greater return than that available “back home”.

This assumption can no longer be made even for Asia and the Pacific and, in the current global environment, there is a very real risk that traditional sources of foreign debt and equity capital used to finance infrastructure and other vital projects in many developing countries will not be available for the tenor needed or at an affordable price. Risk perceptions of FDI have substantially changed, and this has important implications for the establishment of an enabling environment for FDI in emerging markets.

Quality FDI is attracted by an enabling environment, which consists mainly 1) of political and economic stability, 2) an appropriate institutional framework, 3) an appropriate financial sector framework, and 4) the opening of an attractive target market for investors. I will distinguish between a “domestic approach” for establishing an enabling environment for FDI, and an “international approach”. The first three items just mentioned belong to the domestic approach; the fourth item constitutes the international approach.

Before I talk about the environment for FDI in developing countries in Asia, let me touch briefly on the question of the availability of FDI coming from developed countries.

Financial flows to Asian emerging economies

In the last two years private financial flows to emerging economies worldwide have slowed down. In 2000, net private flows amounted to US$188 billion and the IIF estimates net private flows in 2002 to be US$123 billion. FDI decreased over this period from $135 billion to $113 billion. In line with this global trend, net private flows to the Asian and Pacific region decreased from about $75 billion in 2000 to about $60 billion in 2002.

Asia and the Pacific have exhibited some special characteristics in terms of financial flows. A) In absolute terms, Asia and the Pacific received the biggest volume of net private inflows compared to other developing regions. B) FDI makes up the largest portion of these flows, net official flows to the region being zero or slightly negative. C) Most of the private capital inflows to Asia reflect the **sustained and increased** level of FDI to the People's Republic of China. In the region around 80 per cent of FDI ends up in China. So one should have a quick look at China first, when talking about FDI in Asia.

Enabling Environment for FDI: a first look at the PRC

FDI inflows into the People's Republic of China (PRC) have increased since 1992 and reached a new record of $47 billion in 2001. This large amount dwarfs the inflows into other emerging market economies in Asia. FDI has played a major role in the PRC's transition to a market-based economy, and it has been an effective way to transfer technology and managerial expertise to the PRC. What makes PRC so attractive for FDI?

a) The country's market potential, particularly since it joined the WTO, is seen as the most crucial factor for investing in business climate surveys conducted by ADB. Other often cited reasons are strategic in character such as pre-emptive investments to keep a foothold in a potential increasing market, and the need to service multinational clients operating in the country.

b) Some of the market potential is already being realised through the sustained high rates of economic growth and the associated growth in market size.

c) The country has established political and macro-economic stability which has been maintained during the Asian financial crisis, and which has given China an advantage in the eyes of foreign investors.

In terms of market potential, market growth and overall stability, the PRC might be considered as an exception in Asia. The country is able to attract vast FDI despite having not fully put in place an overall enabling environment. The institutional capacity for a modern enterprise economy is not fully in place. The legal environment needs strengthening. Private property rights are not always accorded the same treatment as public property rights. Although an adequate legal framework exists in many areas, enforcement is not consistent. The state banking system is saddled with large NPLs, and the financial sector is insufficiently diversified. ADP conducted business climate surveys of foreign and domestic private firms found several major impediments, including: (i) an inadequate legal environment; (ii) a weak financial sector, limiting financing operations; and (iii) poor access to reliable information and professional services. Moreover, there remains the issue of economic and social disparities in the country, an issue which requires a comprehensive policy approach.

Record of FDI to other Asian and Pacific Economies compared to China, and a domestic and international approach to establishing an enabling environment.

In 1999 and 2000, FDI to the PRC amounted to 10.5 and 9.5 per cent of purchasing power GDP. In comparison, Vietnam achieved FDI of 22.1 and 15.1 per cent, India 2.1 per cent in both years, and Thailand 23.8 and 12.2 per cent in 1999 and 2000. In absolute terms in 2000, Vietnam received $1.3 billion, India $2.3 billion, and Thailand $3.4 billion, which pales in comparison with China's $38.4 billion. Indonesia experienced substantial FDI outflows of $4.5 billion in 2000. The relatively low absolute inflows into countries other than China, suggest there is room for attracting further FDI to these economies. And since China cannot be most competitive in all sectors compared to many of its neighbours, countries will have the opportunity to exploit market niches and attract FDI complementary to China's productive resources. What will they have to do? Overall, I suggest they have to close the credibility gap that exists between them and China in the eyes of the foreign investor.

Political and Economic Stability: I believe that ADB's developing member countries need to create an environment that will attract long-term capital based on fundamentals such as lower domestic and external imbalances, political stability, willingness to reform, domestic savings and economic growth.

While fundamentals are important, there are indeed additional policies that host governments can adopt to attract FDI. Foreign investors prefer a social and political structure that cannot be threatened in a prolonged economic downturn. A stable exchange rate tends to attract more direct and portfolio investment.

Appropriate Institutional Framework: Ineffectiveness in attracting FDI suffers from weak tariff regulation, reluctance in honouring concession commitments, inconsistent enforcement of laws, corruption, poor governance practices, weak accounting and disclosure norms and weak securities legislation.

Often there has been failure to separate regulation from administration in order to avoid conflicts of interest. Many countries in our region have been slow to establish autonomous regulatory agencies with sufficient professional capacity.

ADB conducts policy dialogue with governments on needed reforms and encourages the introduction of regulatory frameworks that strengthen market institutions and establish social protection programmes. Such frameworks allow deregulation and encourage competition.

Appropriate Financial Sector Framework: Strong financial systems are needed to support balanced growth. Emerging markets in Asia need to aim for well-capitalised financial systems with a manageable level of non-performing loans.

Policy objectives – such as strengthening banking systems and developing long-term investing institutions and bond markets denominated in domestic currency – would complement each other to bring better balance to both capital flows and economic structures. Institutional investors can then provide quality non-opportunistic FDI through matured capital markets.

Once the second and third elements are in place, a country is well-positioned to attract FDI even in the shadow of a large Chinese market. The credibility gap between China and the rest of developing Asia will be closing in the eyes of the investors. I call these just listed factors the domestic approach to closing the credibility gap, as these factors are under the influence of domestic parties.

Regional Co-operation to Enlarge the Market: There is the additional factor that can help to bridge the credibility gap. To reap the benefits from this factor in place, international co-operation is necessary. I call this the international approach. Regional and sub-regional co-operation has emerged as an increasingly important development strategy in Asia. Such co-operation offers larger markets that allow economies of scale in comparison to China, and efficient division of labour with China to match foreign investors' desire for strategic operations from a global point of view. Economic co-operation can make a sub-region as a whole relatively more attractive for FDI by extending access to factors of production, products and markets beyond national boundaries.

Case Study

To give you a current example of how ADB along with other multilateral and bilateral institutions actually helped bridge the creditability gap faced by foreign investors wanting to make an investment in a constrained market, I would now like to briefly talk about the Phu My 2.2 Power Project in Vietnam, which achieved financial closure last month.

For this power project in Vietnam, $100 million debt from offshore commercial banks is being mobilised with the benefit of political risk guarantees issued by ADB and the World Bank. $240 million of direct loans will come directly from ADB, JBIC and Proparco (financing entity of

Govt. of France), while $140 million in equity will come from Electricité de France, Tokyo Electric Power Company and Sumitomo Corporation.

This 715-megawatt gas-fired combined-cycle power plant is being developed and implemented under a 20-year BOT contract between Vietnam's Ministry of Industry and a special purpose company.

The project, just outside Ho Chi Minh City, will help prevent anticipated power shortfalls, as power demand in Vietnam is conservatively estimated to grow by at least 8 per cent per annum over the next two decades. In addition, the project will stabilise power supply by reducing Vietnam's dependence on seasonal hydropower generation.

This project helps Vietnam decrease its credibility gap with foreign investors:

It marks the first time in Vietnam that a power contract has been awarded through a transparent and internationally competitive bidding process, following international best practices and standards of governance in the award and development of infrastructure concessions. The project has catalysed the Government on needed reforms in the power sector, and it encourages the introduction of regulatory frameworks that strengthen market institutions. Such frameworks allow further deregulation and encourage private competition.

The project helps the development of a more diversified financial sector. First this happens through the direct loan that is commercially priced with a maturity of up to 15 years, which is fairly long by current market standards. Second it is through the political risk guarantee covering commercial banks against the risk of the host government being unable to meet its obligations under a variety of project agreements – thus bridging the credibility gap between the investors and the host government.

And finally, to help encourage "supply" of risk-taking capacity in Vietnam, ADB's political risk guarantee will be underwritten by a private political risk insurer and issued by ADB as a guarantor of record thus giving the private insurer the benefit of ADB's preferred creditor status.

Conclusion

Various factors have contributed to a diminished “push” of FDI from developed economies to emerging markets in Asia. Nonetheless, FDI is still available in substantial amounts in Asia, particularly to the PRC. To which economies FDI is directed, depends very much on the enabling environment for FDI, or the “pull” factors. The enabling environment can be established through a combined domestic and international approach. Maintenance of political and economic stability is of overriding importance. A strong and transparent legal regime and a developed regulatory environment are key. The establishment of competitive components in infrastructure and strong domestic financial systems are also of importance. Regional co-operation and market integration can add to the countries' attractiveness for FDI. Even in the absence of a strong enabling environment which takes time to establish, investors are looking for new ways to finance FDI, focusing on the provision of structuring and underwriting assistance to bridge the creditability gap faced by foreign investors in emerging markets.

COMPETITION FOR FOREIGN DIRECT INVESTMENT: ITS IMPACT ON WORKING PEOPLE

G. Rajasekaran
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Introduction

Labour relations and trade unionism are issues generally perceived as problems of modern capitalism. Industrial relations experts seldom deal with "labour problems" of the industrialised non-capitalist societies and their "command economy" for reasons not often explained. Nevertheless, since the collapse of the Marxist regimes, and the transformation of their command economies, analysis on labour relations at the global level must take into account the fact that these former non-capitalist countries are now new players in this complex capitalistic game. This paper tries to analyse labour relations situation in a rapidly changing global economy in which liberal capitalism as well as the various mixed-economies are important players.

Prior to the era of globalisation, industrial relations were mainly perceived as issues related to class relations under capitalism. During the period from 1919 to late 1980s, the ILO (especially its labour group) played a crucial role in minimising class antagonism at work places so that the problems of class exploitation under the capitalist relations of production could be reduced. Their fifty-year efforts have eventually produced what is known today as the International Labour Standards. Globalisation takes place after modern capitalism manages to have comprehensive conventions and rulings which govern employees-employers relations as well as dealing (mediate and arbitrate) with work-place disputes. The presence of these conventions and rulings, among others, make it possible for modern capitalism to be liberalised and becomes the global economic system. But, for a long time, these International Labour Standards have not been enforced throughout the world due to the fact that the ILO has no enforcing power to do it. The industrial relations system in ILO's member countries has been developed through voluntary initiatives. This continues to remain a main weakness of the system.

With globalisation, industrial relations system through out the world seems to have a completely new dimension. Labour relations have become a part of bigger and strategic international relations between three categories of countries and economies: the developed capitalist countries, the industrialising capitalist countries and countries formally practising command economic system. Hence, labour relations have become a very complex international relations game.

The setting up of the WTO in 1994, with its "enforceable power", makes it viable for the ILO's International Labour Standard to be enforced through out the world, including into the former non-capitalist economies. The labour group in the ILO began to see the prospect for the whole world to have a common labour relations principle. Nevertheless, this idea was rejected by most industrialising countries based on the argument that, given the global social and economic inequality, developing countries will not be able to comply with the international labour standard, developed based on the experiences of advanced countries.

The labour relation's game changed significantly when China became a member of WTO. China joined the WTO with only a small portion of her command economy already transformed as a market entity. Nevertheless, this market entity is large enough in terms of its export contribution to the world market and attractive enough in terms of its ability to attract direct foreign investment of trans-national capital. At the same time, the Chinese producers and exporters are able to flood the world market with goods at rock-bottom prices. For these three recent development, newly industrialised countries like Malaysia, are facing serious challenges in maintaining the viability and prospects for their manufacturing sector, in protecting jobs and employment opportunities for their labour force, and in assuring the competitiveness of their products (in terms of prices) in the international market. Governments of developing countries, including Malaysia, insisted that WTO should deal with trade matters only and ILO is the appropriate organisation to promote labour standards. Yet these governments have made very little effort to ratify core conventions and those who have ratified have not put in place appropriate legislation to ensure enforcement.

Competition for FDI

Cheap labour policy

Malaysia hopes to take advantage of globalisation by attracting foreign investments and expertise by announcing to the world that its labour is cheap and good. By this means the state thinks that the much needed capital could be attracted leading to the development of certain sectors. In the foreign dominated manufacturing sector, workers are paid poor wages and their right to join unions is strictly controlled and often made extremely difficult. Thus, the absence of national unions in the electronics sector has prevented workers from demanding wage increases. In fact, foreign investors were encouraged to invest with many incentives provided by the state. Other than the generous provision of tax incentives, the state also enables foreign capital to repatriate their profits without any hindrance and at the same time ensures that there would not be any national unions formed to challenge the multinationals. It is argued by the state that existence of national unions might give rise to disputes on wage matters.

Because of the influence exerted by foreign multinationals, the state refuses to budge on the question of allowing for the formation of national unions. It is feared that the appearance of national unions would push wages upwards. Thus due to the lack of trade unions rights, wages of workers in the electronics sector is about one-third of the wages paid in Singapore. Moreover the use of female labour and to some extent foreign migrant labour is intended to depress wages. It was found that women who work in the manufacturing sector do not work for many years.

Keeping production costs down seems to be the main concern of foreign multinationals in the manufacturing sector. A recent study points out that almost all the foreign companies in this sector are not very comfortable with unions. While the American companies are not prepared to tolerate trade unions whether they are national or in-house, Australian and Japanese companies are somewhat more flexible. However, despite this difference, it was found that all the companies prefer to function in an environment where there are no problems with unions.

Malaysia's reliance on foreign migrant labour is another feature of its cheap labour policy to promote the interests of capitalists. It is estimated that there are nearly 1.5 million migrants in the country, about 50% without work permits. Migrants dominate such sectors as construction, plantations and domestic services. The tendency on the part of Malaysia to move away from these sectors and the relative high cost of hiring locals have pushed employers and the state to bring foreign migrant labour. Needless to say, migrants are paid low wages and subjected to all kinds of restrictions. Recently the state was able to deport about 300,000 illegal migrants, before it realised that their total removal would jeopardise the economy. Diplomatic row with Indonesia and the Philippines and strong opposition from local employers also factored in the state's decision to halt the deportation exercises.

The reluctance on the part of the state and employers to agree to the Malaysian Trades Union Congress (MTUC) request for a basic minimum wage represents another instance of adherence to cheap labour policy. For many years, the MTUC has been struggling to provide a minimum basic wage for workers in the country. Every time the issue of a minimum wage came up, the employers would reject it by asking for commensurate productivity increase. About more than a year ago, the MTUC proposed a basic minimum wage of RM 900 for workers in the country. However, the proposal was not discussed by the state or employers. It would be impossible for the minimum wage to be implemented for workers unless and until the state abandons its cheap labour policy. The call for the introduction of a basic minimum monthly wage for oil-palm plantation workers resulted in the provision of meagre sum of RM 325 per month. Analysts argue that since the average monthly income for oil-palm harvesters and factory worker are in the region of RM 550 and RM 450 respectively, the new monthly wage is not applicable at all.

There are contradictions in the pursuance of a cheap labour policy by Malaysia. While it might endear Malaysia to global investors, it has the ability to constrain the economy from fully developing and promoting the skills and expertise of the workforce. As long as Malaysia is going to hold on to this policy, chances are that little attention will be paid to enhancing the productive value of labour. But then, considering the nature of investments in the country especially in the manufacturing sector, it would be difficult to make a strong case for the qualitative transformation of labour. Therefore, unless and until the state pays attention to general labour mobility, provision of freedom of association and necessity for workers to bargain and determine their conditions of employment, human resource transformation might not be possible.

Freedom of Association

The International Labour Organization (ILO) stipulates freedom of association as one of the core labour issues that should be adhered to by all countries. But then appeals, reports and recommendations of world bodies such as ILO, United Nations, International Confederation of Trade Unions do not seem to be heeded to by countries hungry for development funds. The need to attract capital with the provision of generous conditions is making a mockery of freedom of association, one of the fundamental aspects of human rights. The general decline of union membership over the years is a result of many factors; one of which is the absence of freedom of association. In Malaysia, trade unionists are of the opinion that it is the lack of freedom of association that is preventing the growth of union membership.

Given the subservient role of the state in its relationship with global capital, laws and regulations will be used to ensure that workers wanting to form new unions or seeking affiliation with the already existing ones will be subjected to a lengthy bureaucratic process. If it is possible for the state to prevent the formation of new unions, it will do so. However, sometimes it adheres to the practice of influencing workers to form in-house unions rather than national unions. Even the formation of in-house unions is not high in the country. Employers especially in the manufacturing sector are not too keen to have unions, whether they are in-house or national unions. Even if the state allows for the formation of in-house, the obstinacy on the part of employers in not recognising unions stifles the union formation process.

Violation of Trade Union Rights

Employers generally are not very sympathetic to union formation in the country. The state's attempt to accommodate the concerns and interests of global capital, has only emboldened employers in the country to have a blatant disregard for workers' rights to join trade unions to protect their collective interests. The Industrial Relations Act of 1967 protects the trade union rights of workers but, in practice, the state has been unable to check some of the worst abuses of employers. In January 2001 more than 1500 employees of Ramatex Textile Industries picketed to protest against the management's refusal to recognise the union. In October 2002, Ramatex removed safeguards and security of tenure for all its employees. Dutch Multinational Shell Malaysia, redesignated all clerical and junior staff as junior executives, in order to deny them continued union membership and collective bargaining rights: Labour legislations in most Southeast Asian countries restrict union membership to non executives. The banking sector is currently on a major union busting campaign, in order to arbitrarily change working conditions.

Currently at least ten complaints of union busting activities by Korea, Japan and the United States based companies are pending in Malaysian Courts; causing extreme frustration to workers efforts to organise and seek collective bargaining on terms and conditions. These unprecedented events are seen as a product of globalisation and workers and trade unions in most developing countries are witnessing such an unhealthy trend on the increase and relevant authorities are reluctant or unwilling to act.

Free Trade Zones (FTZ/EPZ)

FTZs mainly established to attract FDIs have been in existence for more than two decades: providing special privileges, tax holiday, exemption of minimum standards under countries labour laws, restrictions and in some countries like Bangladesh a complete ban of trade unions.

These special privileges were supposed to be temporary to help developing countries create employment, technology transfer and skill development and there were indications governments were keen to fulfil their early promise. However events of the past twelve months have drastically changed government thinking.

Recently Korean trade unions reported that Government has tabled a new bill to establish EPZ's with special privileges to attract FDI.

Campaign and demands by corporations for more concessions

Electronics MNCs want everlasting pioneer status

> "The electronics industry continues to be Malaysia's key exporter accounting for more than half of the country's exports of manufactured goods, hot on the heels of the booming Internet-based New Economy. But after three decades of enjoying its "pioneer status" that comes with huge tax concessions, guaranteed low wages and subsidised public amenities, these semiconductor fabrication facilities or fabs are asking for more of the same or they may go elsewhere."

[Sunbiz September 1, 2000]

Hi-tech firms review investment incentives

“A review of investment incentives accorded to IT companies in Penang is under way to seek feedback on how Malaysia can enhance its competitiveness.

“The assessment of the incentives will be carried out by the Free Industrial Zone Penang Companies’ Association via a questionnaire, with its findings to be submitted to the Federal authorities by year-end.

“We aim to present to the Federal Government the competitive advantages being offered by other countries to investors in a bid to enhance our own competitiveness.”

[New Straits Times September 25, 2001]

ASEAN sees China’s rise a major concern

“The rise of China’s economic power and the consequent short and long term impact on the economies in the region have caused great concern among ASEAN’s business community, said Malaysia-China Chamber of Commerce President Tan Sri Ngan Chin Wen.

“He said ASEAN would see its global market share and foreign direct investments being further eroded with the rise of China as an economic power, unless business communities come up with viable plans to work together with their counterparts in China.”

[SunBiz 20 July 2002]

Singapore FTAs spurred by need to strengthen links

“With rapid liberalisation worldwide, ASEAN now has to compete hard for investments, particularly with China which has received nearly 40 per cent of the FDI inflows into Asia between 1995 and 2000.

“He added that some investment banks predict that FDI into China could rise from US$40 billion-US$45 billion level to US$100 billion.”

[Singapore High Commissioner, Mr K. Kesavapany – Business Times 14 August 2002]

Asia keeps wary eye over China’s rapid growth

“The rest of Asia has spent the past few years with a wary eye on China, home of the fastest growing local economy and the region’s fiercest competitor. Those fears are about to get worse.”

[New Straits Times 26 Jun 2002]

Capitalist globalism and social justice

“Unlike previous waves of globalisation, where religion and politics took the lead, this time the single most important influence is economics, more exactly, capitalist economics as epitomised by multinational corporations (MNCs). Not unnaturally, therefore, the end result is a world where social justice is a mere by line to the overriding rational of profit maximisation.

> “The WTO is the apogee of capitalist internationalism: the borderless, seamless world economy of free markets and open economies where MNCs are triumphant on several counts, none being beneficial to the average individual apart from the prospect of employment.
>
> “In fact, the on line world is an MNC paradise of instant cross-border movement of goods and information. Coupled with an enormous command over financial and other resources only another giant can do battle with what are deceptively dextrous institutions, almost chameleon in their adaptability with size being an important factor: the bigger the better. And, given their lobbying capacity, they can make big political waves tantamount to a tsunami, when it suits them. But for laws restricting this ability, they would have long drowned the world.
>
> “The only way forward, then, to ensure that globalism is not an exercise in the impoverishment of the many by the few, the WTO must be sensibly tempered by some international social justice agenda that is not fragmented over many disparate, supra-national bodies.”
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> *[New Straits Times 6 July 2002]*

Social stability and progress

From its foundation in 1919, the ILO has sought to develop standards in the social and employment field which reflect the interest of all nations in social progress and the development of institutions which enable social problems and conflicts to be resolved. Its standards take the form of principles to be applied in national law and practice. They thus provide a framework which is clear in terms of objectives but provides sufficient flexibility to be adapted to national circumstances.

In recent years, as the interdependence of the world economy accelerated and respect for democratic forms of governance spread, the ILO was able to develop a large degree of consensus over the universal applicability of seven of its most basic Conventions. The ILO Declaration on Fundamental Principles and Rights at Work and its Follow-up, adopted by the International Labour Conference in June 1998, sets out the commitment of the international community to establish a social minimum at the global level which responds to the realities of globalisation. The seven Conventions specified in the Declaration are core labour standards which, where properly observed, create the foundations for a sound system of industrial relations in which trade unions, together with employers and governments, can play a constructive role in working to ensure that social progress goes hand in hand with the progressive opening of markets to international trade and investment. ILO Conventions ratified by ASEAN member countries.

CORE CONVENTIONS RATIFIED BY ASEAN MEMBER COUNTRIES

C29 Forced Labour Convention, 1930

C87 Freedom of Association and Protection of the right to organise Convention, 1948

C98 Right to Organise and Collective Bargaining Convention, 1949

C111 Discrimination (Employment and Occupation) Convention, 1958

C182 Worst Forms of Child Labour Convention, 1999

Convention	Malaysia	Indonesia	Singapore	Thailand	Philippines	Vietnam	Cambodia	Laos	Myanmar
C29	√	√	√	√			√	√	√
C87		√			√		√		√
C98	√	√	√		√		√		
C111		√			√	√	√		
C182	√	√	√	√	√	√			

Conclusion

Powers and influence of MNCs

Respect for freedom of association is central to the attainment of economic development and sustainable growth. The evidence from many industrialised countries - France, Germany, Japan, Norway, etc - indicates the positive link between increasing wages and productivity by improving the motivation of workers. Higher wages also act as a spur to productivity improvements by obliging employers to try harder to make economies on other elements of their costs, so increasing the efficiency of the production process. Furthermore, setting higher social standards often forces employers to upgrade and thereby results in more efficiency and higher growth in the long run.

Trade unions play an essential role in the development process by achieving a sustainable distribution of income and wealth. Unions have played a crucial role in improving the wages and working conditions, so ensuring that the benefits of productivity growth are not confined to a small elite but are distributed more widely over the whole population. Productivity, growth and development all depend upon a generalised perception that the labour market is equitable. Where this does not exist, the consequence has either been stagnation - shown by the below-average long-term performance of many Latin American economies with extreme income and wealth inequality - or social and political instability which has undermined development efforts.

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INVESTMENT FRAMEWORK FOR DEVELOPMENT IN THE WTO AND OECD CONTRIBUTION ON CORPORATE RESPONSABILITY

Robert Madelin
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Investment in WTO: towards a rules-based system

Investment, development and trade are inextricably linked. They have to be dealt with in a more integrated way. We are therefore convinced that there is a need for an Investment for Development Framework in the WTO. This is a need for investors and for Developing Countries. A rules-based system would assist us in harnessing globalisation, as the follow-up of the Johannesburg WSSD requires us to.

This framework should ensure transparency, stability, predictability and non-discrimination, in a manner that would not harm the right of countries to regulate, and that would allow for progressive liberalisation, in a gradual process, as in the General Agreement on Trade in Services (GATS).

A balanced framework of rules on Foreign Direct Investment would be in the interest of developing countries, as a rules-based system will make it easier to attract investment in these countries. Domestic reforms are more credible if backed by multilateral commitments.

The Doha Declaration gave the WTO Working Group on Trade and Investment a clear mandate to clarify some issues fundamental for any future negotiations on a multilateral framework on Foreign Direct Investment. EU is fully committed to this process and has been proactive in the clarification process by presenting concept papers on the seven topics requiring clarification. Constructive debate started in Geneva and all Members are addressing the options available. At this stage, the aim is to reach common understanding and set grounds for negotiations.

The WTO process has taken stock of the 1998 OECD failure. What we try to do in WTO takes account of the weaknesses that existed in that draft MAI, but also takes into account the needs of Developing Countries. Our agenda is flexible and integrates the possibilities for each country to liberalise at its pace, while having a general framework that goes in the right direction in order to create an enabling environment that will foster investment.

The global investment context is wider: CSR contribution

Globalisation raises new challenges regarding how to develop trading relationships that support the UN's Millennium goals of reducing poverty and ensuring greater environmental security. All our policies and especially trade policy must be supportive of and lead to Sustainable Development. Corporate Social Responsibility can contribute to reach these ambitious goals.

In a broader context, CSR can also be supportive of our agenda in the Doha Development round, in particular regarding investment. Indeed, we are of the opinion that companies will, through these negotiations, enjoy better conditions to invest abroad, and thus they have also to accept some principles of good behaviour. Moreover, some countries, mainly developing countries, are still reluctant to admit dealing with this topic in the WTO framework. Giving CSR greater visibility and credibility and stronger accountability may help face this opposition and rally these opponents to WTO-Investment negotiations.

The debate has now moved on from a too simple dichotomy between voluntary versus binding instruments, towards the more challenging objective of effective implementation of commitments and verifications mechanisms in order to ensure compliance. All stakeholders are now waiting for acts to confirm the words. Companies can play a major role in this confidence-building exercise, by endorsing CSR practices especially where they operate in developing countries.

We are of the opinion that WTO is not the best forum to address investors' obligations. Creating a WTO Code of Conduct for investors would (a) limit States' ability to regulate in this field; (b) not lead to standards that would be high enough, and (c) endanger the whole process because a number of States and stakeholders would be reluctant to engage in it.

Instead of this, we think that investors' obligations should be addressed by domestic legislation. Multinational Enterprises should comply with high voluntary standards of conduct wherever they operate.

That's why we are supporting the adherence to OECD Guidelines, because they cover 90% of FDI outflows, in particular ensuring that companies from adhering countries (OECD plus Baltic States, South America, Slovenia and Israel at this stage) commit to high standards of behaviour wherever they operate, including in Developing Countries. The Guidelines also set standards of compliance that are high enough to ensure Sustainable Development.

Raising the level of awareness of the Guidelines in Developing Countries is also essential: Developing Countries can use them in their legislation and network with National Contact Points. They can even set up their own "NCPs" that can provide for a place of constructive dialogue between public authorities, business, trade unions and NGOs.

The caveats of this approach: action is required to remain credible

At international level, the WSSD has recognised the growing importance of CSR. The "Plan of Implementation" (§ 17) calls for enhancing:

> *"corporate environmental and social responsibility and accountability" : Actions would be required to: a) Encourage industry to improve social and environmental performance through voluntary initiatives, including (…) certification and public reporting on environmental and social issues, taking into account such initiatives as (…) the Global Reporting Initiative guidelines on sustainability reporting;*
>
> *b) Encourage dialogue between enterprises and the communities in which they operate and other stakeholders; (…).*

These two aspects, external verification of implementation of CSR commitments, and dialogue with local stakeholders, are particularly important to us.

We call on companies for demonstrating their lead and advance in these areas, by *inter alia*, committing to respect the Global Reporting Initiatives Guidelines when drafting their reports, and to set up stakeholder dialogue with local stakeholders, especially for those companies which operate in developing countries. Indeed, an improved communication can contribute to a better insertion of the foreign company in its local environment, thus maximising positive outcomes and minimising possible detrimental effects.

At OECD level, we think the Guidelines process started well: by consulting largely with civil society during the 2000 review, the Guidelines text encompasses the best multilaterally agreed "checklist" of good corporate behaviour available in town. It also has a universal coverage, since government recommend their MNEs to implement them "wherever they operate" and also because accession to the Declaration is open to non-OECD countries. Lastly, it has an implementation mechanism with the National Contact Points.

That is where we are all expected to deliver, as public authorities, as business, as trade unions, as NGOs: on the concrete and "specific instances" that are foreseen in the Guidelines implementation procedures, accepted at Ministerial level in 2000.

Unfortunately, only too few NCPs are really committed to a real-time *bona fide* process as has been agreed at the highest political level, when it comes to the facts. It is true that a complaint can raise difficult internal procedures in administration, painful reflection on investment of domestic companies abroad, or possible legal questions that relate to other government activities. It is however not a pretext for inaction: NCPs must be committed to action, it is the only way forward to demonstrate that they can bridge a gap in the dialogue among stakeholders, before matters get worse and come to the courts. It is the ultimate objective of the Guidelines: an advance or early warning system that can help mediate flexibly with stakeholders in order to find ways out of problems that might otherwise grow further and create a conflict situation. Guidelines are about "conflict prevention", about addressing the issues in a flexible an open manner, under the auspices of forthcoming public authorities that serve all their constituencies: citizens, NGOs, trade unions, businesses, local authorities, foreign counterparts.

It is thus of the utmost importance that CIME moves on with its work in order to have NCPs work better, to re-establish the balance between confidentiality and transparency as stated in the implementation Decision of 2000, and also to reaffirm the relevance of the Guidelines as concerns supply-chain issues, which are inextricably linked with the Sustainable Development dimension that we are mandated to push forward in all *fora*.

At European level, we have also undertaken major initiatives in the field of CSR. The recent Commission Communication: "Corporate social responsibility: a business contribution to sustainable development" (2 July 2002), has established a European Multi-Stakeholder Forum on CSR and specific thematic roundtables will meet till spring 2004. The trade and international dimension of CSR will be an important part of the agenda.

External Trade and cooperation relations of the EU with Third countries also encompass a CSR dimension. For example, the Association Agreement between the EU and Chile, concluded during the second EU-Latin America & Caribbean Summit held in Madrid on 16, 17 and 18 May 2002, refers to the Guidelines.[1] In the near future, we plan to insert CSR issues and the promotion of OECD

1. A **"Joint Declaration"** will indicate that: "The Community and its Member States and Chile jointly remind their multinational enterprises of their recommendation to observe the OECD Guidelines for Multinational Enterprises, wherever they operate."

Guidelines in our external trade relations (such as the Future EU-ACP Economic Partnership Agreements in the framework of the Cotonou co-operation, etc…). We also think that public schemes that grant public funding to private sector firms can ask from recipients to abide by higher environmental and social standards, such as embedded in the Guidelines, as is already done in the Netherlands.

However, investment and CSR are not enough. We realise this. That's why the EC provides funds for CB/TA to improve the capacity of Developing Countries to attract and to benefit from FDI. This is for instance the case in bilateral agreements of the EC, or in the Cotonou process.

In **conclusion**, in WTO, Dr Supachai called for a new thinking on CSR, and we surely concur with this analysis. This is a cross-cutting issue on a number of WTO aspects, which goes along with new thinking and action on voluntary "vs." mandatory requirements: keeping the competitive edge is part of the CSR objective, together with Sustainable Development. Doing more and better can make your business more competitive and your country a more attractive place to set up a business and to work.

Part III

MAXIMISING DEVELOPMENT BENEFITS: LINKAGES WITH LOCAL ENTERPRISES AND SUPPLY CHAIN MANAGEMENT

SYNTHESIS REPORT

France Benois, OECD

This second session focused on the responsible behaviour of investors in host countries, and on the positive linkages that foreign investors can bring, notably through their supply chain.

Discussions focused notably on the perception that the different stakeholders may have of corporate responsibility, and on how corporate responsibility initiatives could fit into a business model. Participants also considered whether corporate responsibility could be a competitive factor for enterprises, particularly in the current context of ever-increasing competition for investment. Beyond commitments by enterprises to behave responsibly, the question of how such commitments could be translated into actions was discussed, as well as the possible impact on the credibility of such initiatives. Finally, participants debated on the added value of international instruments for corporate responsibility, such as the OECD Guidelines for Multinational Enterprises.

Discussions pointed to the importance of a good investment climate to encourage foreign direct investment. Such a climate, participants pointed out, depended on policies implemented by host as well as home countries. Participants exposed their various country experiences regarding maximising the benefits of FDI. One speaker underlined the constructive outcome of a survey carried out among enterprises investing in a host country, which showed that the operating environment was key to attracting international investment.

The particular situation of small and medium size enterprises (SMEs) in attracting FDI for development was also broached during discussions. It was felt that, in this regard, governments had a particularly important role to play, notably by facilitating matchmaking between SMEs, making available local purchasing bases, and helping SMEs grasp market expectations at the end of the supply chain.

Participants also discussed the issue of corporate social responsibility. Although good corporate behaviour on the part of investors is broadly considered an important factor, participants from the business sector underlined difficulties encountered in trying to maintain high corporate responsibility standards in certain countries with a very competitive environment, and no level-playing field. The trade union perspective also pointed to difficulties facing workers in certain developing countries, where few obligations are enforced *vis-à-vis* enterprises to apply high social standards. In this regard, public and private sector dialogue was underlined as essential to the establishment of a favourable investment climate, for domestic and foreign investment alike.

Nonetheless, it was widely acknowledged that good corporate behaviour is good business, and in the longer term interest of the corporations themselves. In this area as well, the role of host and home countries was underlined as essential: home governments of investors can encourage companies to act as ambassadors for good corporate behaviour, while host governments, notably through their investment promotion agencies, can provide a forum for dialogue on corporate social responsibility issues.

In this area, participants acknowledged the importance of international investment instruments for corporate social responsibility, which represent a framework for positive interaction by all stakeholders. The OECD Guidelines for Multinational Enterprises, the ILO Declarations, and the UN Global Compact were among the instruments mentioned in the discussions as particularly relevant.

Participants underlined, in particular, the unique role of the OECD Guidelines for Multinational Enterprises, as the only multilaterally endorsed and comprehensive code that governments are committed to promoting. Among the essential characteristics of the Guidelines is the fact that they apply to large multinational enterprises, as well as smaller companies. With specific regard to attracting FDI for development, the Guidelines encourage application of the recommendations throughout the supply chain of the companies, and underline the importance of local capacity building. Furthermore, the Guidelines were felt to be particularly relevant for all countries, as they are open to adherence by OECD as well as non-OECD countries. However, the need for a better understanding of the process and mechanisms of the Guidelines for non-members was repeatedly stressed.

In conclusion, participants recognised the importance of an enabling environment and level-playing field for attracting international investment. They agreed that corporate responsibility was a necessary and essential factor in maximising the benefits of FDI for development. They acknowledged that challenges still lay ahead in order to further develop innovative ideas to mobilise all actors in the field, and expressed the desire that such ideas could be further discussed at the annual meetings of the OECD Guidelines Roundtable, and at the next GFII events.

MAXIMISING DEVELOPMENT BENEFITS: LINKAGES WITH LOCAL ENTERPRISES AND SUPPLY CHAIN MANAGEMENT – AN OECD MEMBER COUNTRY PERSPECTIVE

Anna Maj Hultgård
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Introduction

It is widely recognised that foreign investment is important for economic growth and a major catalyst of development. It is likewise recognised that multinational enterprises may contribute to economic, social and environmental progress. The benefits of FDI to local development in host countries are not, however, automatic.

Various measures have to be taken by host countries as well as home countries and the multinational enterprises in order to improve and maximise the contribution of FDI for development.

Host- and Home Country Measures

The overall-policies of host countries as well as a basic level of development are important factors in triggering the benefits of FDI. By enhancing fundamentals for economic growth, such as the local supply of human capital and modern infrastructure, political- and macroeconomic stability and good governance the host-country becomes an attractive location for multinational firms. There is also an increased likelihood that the domestic industry benefits from private participation through spill-over effects, such as technology dissemination and human capital formation.

These are examples of measures to be taken by the host countries. Nevertheless, there are important measures that may be taken by home country governments as well. In a broad sense examples of measures that may be taken include commitment to increased market-access to products from developing countries and restrictions on subsidies and incentives in the home countries which may limit market access.

Home countries may also contribute by providing capacity building and technical assistance in the area of investment as well as promoting technology transfers and the establishment of private-public partnerships.

In this context I would also like to mention the OECD Convention on Combating Bribery as an example of a home country measure. The Convention makes it illegal, in the home country of adhering countries, to bribe public officials in relation to international business transactions, all over the world.

Despite various measures taken by home- and host countries there might be public concern on the activities of multinational enterprises, especially in host countries. Multinational enterprises have attempted to respond to these concerns by way of internal codes of conduct and by issuing policy statements on ethical behaviour.

In order to promote an atmosphere of confidence between the multinational enterprises and the societies in which they operate as well as preventing conflicts, internationally agreed principles are important. OECD countries have launched several initiatives to promote responsible business conduct. Among these, and the most internationally well known, are the OECD Guidelines for Multinational Enterprises.

The OECD Guidelines for Multinational Enterprises

The Guidelines for Multinational Enterprises are part of the Declaration on International Investment and Multinational Enterprises. The Declaration is a political agreement on a wide range of investment issues, such as national treatment, incentives and disincentives and conflicting requirements imposed on multinational enterprises.

The OECD-guidelines are recommendations on responsible business conduct addressed by governments to multinational enterprises operating in or from their countries. The OECD-guidelines are a multilateral code that governments are committed to promote. The guidelines are endorsed by governments of countries that are the source of most of the world's FDI and home to most multinational enterprises, covering operations in both home- and host countries.

In its Ministerial Meeting of June 2000, OECD Ministers encouraged non-members to adhere to the Declaration on International Investment and Multinational Enterprises, including the Guidelines. Adhering countries are at present, apart from the OECD-members, Argentina, Chile, Brazil, Estonia, Lithuania, Slovenia and Israel. In the process of adherence to procedures are Latvia, Venezuela, Romania and Singapore. Adhering countries have to have liberal policies towards FDI and be willing and able to fulfil the requirements of the Declaration and related instruments. To ensure this a full investment review i of the applicant is carried out.

The last revision of the Guidelines from the year of 2000 reinforced the economic, social and environmental elements in the Guidelines. In addition the implementation procedures were significantly improved.

I would like to touch upon certain provisions of the Guidelines that might be of special interest in this context.

The adhering governments to the Guidelines encourage the widest possible use of the Guidelines and thus support small- and medium-sized enterprises to observe the Guidelines, while at the same time acknowledge that they may not have the capacity do so as larger enterprises.

The adhering governments also expects from enterprises, where practicable, to encourage business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the Guidelines.

The enterprises shall, according to the Guidelines, respect human rights and contribute to the abolition of child labour and all forms of forced labour. The enterprises shall encourage local capacity building through close co-operation with the local community, including business interests. The enterprises shall encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees. In their operations the enterprises shall to the greatest extent practicable, employ local personnel and provide training with a view to improving skill levels, in co-operation with employee representatives and, where appropriate, relevant governmental authorities.

Moreover the enterprises shall refrain from seeking or accepting exemptions not contemplated in the regulatory framework relating to environmental, health, safety, labour, taxation, financial incentives or other issues.

According to the environmental provisions of the Guidelines, enterprises shall conduct their activities in a manner conducive to sustainable development, in particular by closely monitoring the environmental and health impacts of their activities, make environmental assessments in the decision-making process and regularly monitor and verify progress in this context. Enterprises shall also continually seek to adopt environmentally friendly technologies and operating procedures.

Furthermore enterprises shall, where practicable, adopt practices that permit the transfer and rapid diffusion of technologies and know-how as well as perform science and technology development work in host countries to address local market needs.

With regard to competition, enterprises shall refrain from carrying out anti-competitive agreements with competitors.

Finally I would like to mention the recommendation on taxation according to which the enterprises shall contribute to public finance of host countries by making timely payment of their liabilities and make every effort to act in accordance with both the letter and spirit of host country tax regulations.

Observance of the Guidelines is voluntary. The Guidelines explicitly acknowledge that the Guidelines are not a substitute for, nor should they override, local law and regulation. They represent supplementary principles and standards of behaviour of a non-legal character.

Adhering governments are nevertheless committed to encourage their observance and to actively promote the Guidelines. Adhering countries shall set up National Contact Points (NCPs). The NCPs undertake promotional activities, act as a discussion forum and handle inquiries or cases if and when questions arise on specific enterprise's behaviour under the Guidelines. The OECD Committee on International Investment and Multinational Enterprises (CIME) is discussing specific and general aspects of the Guidelines, is organising exchanges of views on Guidelines with social partners and non-members and is reviewing the relevance and effectiveness of the Guidelines.

Other ways of promoting the Guidelines may be to work for the inclusion of references to the Guidelines in international investment treaties and to contribute to their circulation by distributing copies in connection with the granting of export credits or investment guarantees.

I would like to take this opportunity to share with you an example of how the Swedish Government is working with corporate social responsibility through an initiative called the Swedish Partnership for Global Responsibility.

The Swedish Partnership for Global Responsibility

The Swedish Government actively encourages Swedish business to behave responsibly and to set good examples. Disseminating knowledge and promoting global regulatory frameworks in the social and environmental spheres within the business sector, are important components of an active Swedish policy on globalisation.

The Swedish Partnership for Global Responsibility is an effort to encourage Swedish companies to be ambassadors for human rights, anti-corruption and a decent and sound environment, all over the world. The point of departure is provided by the OECD Guidelines for Multinational Enterprises and the nine principles set forth in the United Nations' Global Compact, which relates to human rights, labour and environment.

The Swedish Partnership for Global Responsibility is designed to bring clarity to the debate, highlight good examples and help actors learn from each other. Internally, in Government services, it is also meant to facilitate co-ordination on a range of activities on this issue.

The main responsibility rests with the Ministry for Foreign Affairs since focus is on what Swedish companies do in other countries, but the initiative has been taken in close co-operation primarily with the Ministry of Industry, Employment and Communications and the Ministry of the Environment.

Companies can join the Swedish Partnership for Global Responsibility by expressing a will to support and strive for fulfilment of the OECD guidelines and the nine principles of the Global Compact. The companies should include examples on how they work with these issues. Co-operation is displayed by posting the company name and a description of their work on the Government website; www.ud.se/ga.

The Secretariat of the Partnership hosts a number of seminars on specific issues with participants from the business sector, trade unions, NGOs and public administration. All Swedish Embassies have been informed about the initiative and have been invited to take an active part in the Partnership for global development.

Conclusion

In order to maximise multinational enterprises´ contribution to local development in host countries, measures taken by the home country governments as well as the host countries themselves are important. I have given you some examples on how the behaviour of enterprises may be supported and encouraged in various ways.

For the business community to be concerned about responsible behaviour is also good business. International co-operation and initiatives for corporate responsibility, such as the OECD Guidelines for Multinational Enterprises, have proven to be fruitful and effective instruments. Corporate social responsibility is a win-win situation.

SUPPLY CHAIN MANAGEMENT: A BUSINESS PERSPECTIVE

Clarence Kwan, Business and Industry Advisory Committee to the OECD (BIAC)[1]

"Encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the Guidelines."

– OECD Guidelines, 2000

"It is recognised that there are practical limitations to the ability of enterprises to influence the conduct of their business partners..Established or direct business relationships are the major object of this recommendation."

– Commentary on General Policies

"The Guidelines are not a substitute for, nor do they override, applicable law. They represent standards of behaviour supplemental to applicable law."

– Statement of the Chairman of the OECD Ministerial, June 2000

Introduction

The extent to which businesses engaged in global commerce adhere to labour and environmental standards is primarily an issue of national governance rather than supply chain management. In countries where laws governing anti-competitive business practices, environmental protection and labour standards are effectively enforced, companies can rely on the government t to ensure that their suppliers are, at a minimum, in compliance with local law. However, in countries where such laws exist but are not effectively enforced, the question of whether suppliers meet these legal requirements or not is much more difficult to determine. In the short term, business can help to address this situation through voluntary efforts and in partnership with governments and others.

The ability of companies to respond to this issue varies greatly by sector, location, contract terms, and type of products or services being provided. Most customer-supplier interaction is focused on production issues of product design, performance, cost and quality. More recently, an increasing number of companies have begun to voluntarily monitor the activities of direct suppliers in other areas, including those covered by the OECD Guidelines for Multinational Enterprises. However, it is clear that this type of engagement is voluntary and is not possible in all situations, even with respect to direct suppliers, due to the complexity of the supply chain, the sheer number of suppliers, or a limited ability to influence suppliers' behaviour.

As corporate responsibility covers a wide range of issues and is affected by the actions of many different actors, companies implementing corporate responsibility programs must prioritise both the various issues to be addressed and the relevant audience, including employees, local communities, and

1. Business and Industry Advisory Committee to the OECD.

suppliers. Any discussion of the supply chain in the context of corporate responsibility must recognise that other issues or activities may take priority depending upon the specific situation of each company. This discussion paper presents BIAC's (Business and Industry Advisory Committee to the OECD) views on these issues and the degree to which the OECD Guidelines can serve as a reference point for all companies in the supply chain.

An Overview of Supply Chain Management

A supply chain is a network of facilities and distribution channels that encompasses the procurement of materials, production and assembly, and delivery of product or service to the customer. Included in each of these functions is the management of inventory and returns of product or material to suppliers, both of which are influenced by promotional and sales activities. The complexity of the supply chain and the business relationship between the various components varies greatly from industry to industry and company to company. Supply chains range from fully vertically integrated ones, where a single company owns an entire process of production, to those where each stage of the chain operates independently.

The industrial and logistical co-operation between manufacturers and their business partners has intensified over the last decades. "Suppliers" are no longer restricted to traditional component suppliers. Suppliers have become complex (technical) solution partners ranging from large multinational companies often larger and more "global" than the manufacturers to small but nevertheless very competitive design and engineering firms.

In many areas, industrial and consumer markets have become highly fragmented, with the relatively customized products targeted to a narrower customer base. Supply chain systems require co-operation on a worldwide basis, although the "global market" is still characterized by many local and regional differences. In some industrialising countries, products are assembled with local components due to customs savings or local content requirements. As a consequence, an increasing number of manufacturers have moved beyond setting and controlling product quality standards for their up-stream and down-stream business partners and have begun to include environmental aspects of production processes in their requirements.

Supply chain management has been the focus of aggressive initiatives in many industries over the last decade designed to improve operational efficiencies, shorten product development cycles, increase product variety, improve quality and customer satisfaction, and better link the supply chain with demand and sales forecasts. Information technology plays a critical role in the integration of the supply chain, improving knowledge along the chain and increasing control of supply operations. However, there are clearly limits to such integration, and companies must be careful not to interfere with the independent management of their business partners since such partners will know best what is feasible and cost-effective for their business.

The OECD Guidelines refer particularly to suppliers and sub-contractors, that is, parties up the supply chain. This reflects the logic that some companies may be in a commercial position to encourage some direct suppliers and sub-contractors. The same does not necessarily hold true of customers or others down the supply chain, especially if national law prohibits a refusal to deal with any customer in many circumstances.

The Role of Government

Government implementation and enforcement of national laws and regulations are essential for creating competitive markets, protecting the environment, and safeguarding individual rights. Most countries around the world have laws governing these issues in place, but in some countries a lack of resources and an inadequate institutional infrastructure inhibits the ability of countries to effectively enforce these laws. The only long-term solution to such failures is for governments to create an enabling environment for investment-led domestic growth that will create the resource base necessary to implement and enforce the law on all companies, regardless of size or nationality of ownership.

The relationship between national laws and the Guidelines' recommendations are also very relevant to the discussion of corporate responsibility, as conformance with applicable laws and regulations is the most basic responsibilities of individuals and companies alike. Almost all codes of conduct and company policies include legal compliance as an obligation and state that compliance with host country law is the minimum level of performance acceptable. Indeed, even the performance level against which most private auditors measure suppliers' facilities is usually based on national law. Furthermore, the scope for voluntary initiatives in respect of direct suppliers and sub-contractors is limited in the presence of a comprehensive democratic legal framework.

The Guidelines, of course, go beyond national laws, "providing voluntary principles and standards for responsible business conduct consistent with applicable laws (emphasis added). In the absence of such laws, e.g., freedom of association, how is a global company to use these voluntary principles in guiding its own internal corporate responsibility programs and procedures? Should it advocate for freedom of association in countries where it is prohibited?

Promoting Principles for Corporate Conduct:

Many companies have developed internal policies or codes of conduct that integrate social and environmental aspects into their business plans. In doing so, companies have found that they can discover areas of strategic advantage, and improve their management systems. Integrating such aspects into performance objectives has also helped businesses focus on a central issue for every enterprise: improving the lives of the people involved in its business operations. Improved performance in these areas is frequently cited as generating intangible assets, such as employee commitment and customer brand loyalty, which may lead to improved financial performance.

Companies have also found benefits from doing business with suppliers and sub-contractors who embrace high standards of business conduct and who demonstrate commitment to those standards through their business practices. At a minimum, business partners are expected to be in compliance with all relevant laws and regulations, particularly given the potential risks to the companies' public reputation. Companies in several industries, with a manageable number of direct suppliers and sub-contractors, promote corporate responsibility objectives with those business partners. Before committing to a contract, a growing number of companies ask their suppliers and sub-contractors to commit to terms regarding their legal, environmental and employment standards. Such voluntary initiatives by companies have been very useful in supporting a business culture that minimises corruption and encourages full compliance with all relevant laws and regulations. But not all companies have the means or capacity to do so.

Practical Limitations of Influencing the Supply Chain

Yet, in the United States, it has been estimated that worldwide, some 80 000 factories employing millions of workers feed the appetite for consumer goods.[1] Some argue there are tens of thousands more than that. One large US retailer alone buys from more than 20 000 factories worldwide. It is evident that not all enterprises can promote and monitor observance of corporate responsibility

1. Vickery, Tom. "Global Sourcing: Not Just Ethical, but Economical." Reuters, 1 April 2002.

objectives throughout their supply chains. They quickly run into logistical and financial requirements that far exceed their capacity. An enterprise's ability to promote corporate responsibility principles, like those outlined in the OECD Guidelines, will depend on the industry in which it operates, the quantity of suppliers, the structure and complexity of the supply chain, and the market position of the enterprise. Some examples of the business relationships that limit an enterprise's ability to promote implementation of principles of corporate conduct include:

- Companies that purchase commodities as raw material for their products buy such goods in middle markets, and not from the farms or factories that produce the goods. Commodity markets have hundreds or thousands of small producers feeding into it, making it virtually impossible to identify the supply chain.

- Some companies' purchases represent a small portion of a particular supplier's output, leaving the customer with very limited influence over the supplier's operations. In such cases, the customers may be able to communicate its policy, but will find it difficult to demand observance. In addition, a supplier with several contracts may find that they are being asked to subscribe to multiple different competing corporate responsibility initiatives. And in markets with a monopolistic or oligopolistic structure, the supplier is in a strong position to disregard the promotion of codes of conduct by its clients.

- Companies in some sectors have thousands of suppliers and supply chains that are both complex and deep. These enterprises may be able to communicate corporate responsibility principles to a limited number of suppliers with which they have direct relations, but cannot feasibly communicate them to all indirect suppliers deeper in the supply chain. One United States footwear and apparel company that applies its code of conduct throughout its supply chain has more than 750 suppliers in 52 countries, which is small relative to comparable firms in the industry.[1]

- Many businesses rely on short-term contracts with suppliers and change suppliers frequently. In such businesses, promoting corporate conduct activities along the supply chain would lead to costly frictions.

- In all sectors of government procurement or suppliers owned by government (e.g. public utilities) it can be extremely difficult if not impossible for private companies to promote codes of conduct or to alter the practices of suppliers.

The more serious limitation of applying corporate responsibility through the supply chain, however, may be its inability to reach the vast majority of people in the world who produce goods for local consumption or work outside the formal economy. For these people, attempts to enforce local law through the global supply chain would bring little or no benefit. As stated above, the only real solution that will reach this majority of the world's people is the implementation and effective enforcement of national laws.

Supply Chain Management and Control

Some enterprises have voluntarily opted to engage in more extensive reviews of their suppliers' performance in certain areas deemed of importance by the company in order to match the supplier's

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1. Ruggie, John Gerard. "The Theory and Practice of Learning Networks: Corporate Responsibility and the Global Compact". JCC 5, Spring 2002.

values with the company's. Some companies have established monitoring and assessment mechanisms that may lead to cancelled contracts if a supplier is found to be in continuous violation of certain corporate responsibility objectives, such as the use of child labour or forced labour. Many enterprises have committed to assisting suppliers to meet the enterprises' objectives through training programs on labour and environmental standards and helping them to understand the bottom-line benefits of observing such standards.

Yet, the costly nature of monitoring suppliers' observance of a code of conduct or corporate responsibility objectives may be an obstacle for most enterprises. For example, after reports of poor working conditions and abuse of labour standards in one supplier in Central America, a US apparel retailer decided to establish a group of local union, religious and academic leaders as independent monitors to meet regularly with workers to hear complaints, investigate problems and look over the books of this supplier. The retailer spends US$10 000 a year for the independent monitors at the supplier, which is owned by investors from a third country, and thousands more for management time to arbitrate disputes and for its own company monitors to recheck facts on the ground. For this enterprise to duplicate these intensive efforts at each of the 4 000 independent factories with which it contracts would cost the equivalent of 4.5 per cent of its annual profit of US$877 million in 2000.[1] Many companies find that they must rely on suppliers to monitor themselves and pursue corporate responsibility objectives out of their own self-interest.

There are a handful of multinational enterprises that have set up mechanisms for independent, external auditing of supplier's observance of corporate responsibility objectives. However, it is not economically or logistically feasible for all enterprises to monitor and audit all their suppliers. The best way to monitor and audit the social and environmental performance of all firms is for national governments to implement and enforce national laws and regulations that protect workers and the environment. These examples reinforce the fact that the monitoring and auditing costs will lead to competitive disadvantages if the monitoring and auditing of the supply chains primarily focused on developing countries.

The way companies communicate their commitment to corporate responsibility and relationship with their suppliers also varies from enterprise to enterprise. While some companies make their corporate responsibility policies public and/or subscribe to outside corporate responsibility initiatives, others develop their corporate responsibility policies and programs internally and disseminate the policies throughout the enterprise without making them widely available outside the firm. Different public reporting approaches are also used, including issuing corporate responsibility-specific reports, incorporating corporate responsibility into annual reports, posting information on company Web sites, and/or publicising corporate responsibility practices through business associations. Some companies also use the processes to develop such reports as a means to promote greater transparency and interaction with shareholders and others.

The OECD Guidelines provide companies with guidance as to principles of corporate conduct to integrate into their management systems. The Guidelines do not call on companies to monitor, audit or report on their efforts to promote principles of corporate conduct, but instead leave these decisions to companies to determine what course of action best fits the business reality and the local context.

1. Kaufman, Leslie and David Gonzalez: "Labor Standards Clash with Global Reality", New York Times, 24 April 2001.

The Way Forward

The complexity of this discussion points to the fact that efforts by companies to promote voluntarily corporate initiatives through supply chains should not divert attention from the primary means for promoting environmental and social protections the implementation and enforcement of national laws and regulations. Competitive markets depend on governments to set a level playing field and to establish appropriate rules in areas such as corporate governance, financial disclosure, bribery and corruption, truth in advertising and product safety. Regulatory frameworks for environmental protection and labour rights are also essential aspects of the government's role in protecting the broader social interests. Indeed, the most basic responsibility of all actors in society, including business, is to respect and uphold the rule of law. Global improvements of labour and environmental conditions have to be seen as a long-term project.

In countries or regions with ineffective domestic governance, corporate responsibility initiatives may be used to promote good business practices, but should not be seen as a long-term solution. The OECD Guidelines, themselves, are not meant to substitute for national laws. Private entities cannot and must not replace governments with open and transparent rule-making processes.

Business generally agrees that the best way to promote improved labour and environmental standards in a direct supplier or subcontractor is to convince them that it is in their interest to improve standards and conditions and that it will have a positive effect on their bottom line. Companies work with their supply chains to promote corporate responsibility principles, because they believe in doing business with suppliers and sub-contractors who embrace high standards of ethical business behaviour and who demonstrate commitment to those standards through their business practices. Leading by example will be more successful in the long run.

SUSTAINABLE FOREIGN DIRECT INVESTMENT – SUPPLY CHAIN MANAGEMENT AND LABOUR RIGHTS IN CHINA[1]

Serena Lillywhite
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This paper[2] will explore the relationship between sustainable foreign direct investment and responsible supply chain management in China. First, it will give an overview of the realities of foreign direct investment in enterprises in China, drawing on the Brotherhood of St Laurence experiences in attempting to responsibly manage the supply chain of its optical business – Mod-Style. Second, it will identify the issues, opportunities and limitations facing both multinational and small to medium-sized enterprises that are committed to ensuring they have a positive impact on supply chain decisions. Finally, the paper will discuss the global integration of trade and investment, and the role of the OECD Guidelines for Multinational Enterprises and their contribution to supply chain management.

Introduction

Foreign Direct Investment (FDI) is by no means new, yet there is increased recognition that the benefits of FDI do not automatically and evenly flow on to all.[3] A further development is the growing global awareness that trade and investment are increasingly integrated and that FDI needs to be sustainable. Sustainable FDI necessitates consideration of the economic, social and environmental impacts of investment. It means that investment needs to be driven by more than cheap labour and raw materials, and requires investment in labour and the protection of labour rights, technology transfer, education and training and protection of the environment.

The idea of socially responsible investment (SRI) is also gaining momentum amongst portfolio investors and therefore needs to be considered as part of the global debate on international investment. This will require an increased willingness by enterprises to accept responsibility for labour and environmental standards and conditions within supply chains. Corporate governance, labour standards, corruption and the environment are likely to be the major issues for SRI investors,[4] and appropriate criteria are required for all offshore supply chains and trading relationships to determine if a company in China is eligible for SRI funds. With China's accession to the WTO and the forthcoming Olympic Games in 2008, many foreign enterprises are assessing the opportunities and risks associated with doing business in China. This is set against the backdrop of a business culture and regulatory framework that continues to offer FDI incentives – namely, cheap and compliant labour, a stable political environment and a relatively (compared to other developing countries) well developed infrastructure. In considering FDI, it is important to recognise that an economy based on exploitation and the erosion of workers rights cannot lead to sustainable development.

Foreign direct investment in China – the realities of corporate responsibility in supply chain management

Case Study: Experiences of an Australian non-government organisation (NGO) managing a supply chain in China

The Brotherhood of St Laurence (BSL) is an Australian welfare organisation with a vision of promoting social justice and a whole of society framework for a poverty-free Australia.

In 2000, the BSL gained ownership of a small business, Mod-Style. Mod-Style imports and wholesales optical frames to Australia's independent optical retailers. In 2001-02, the company imported 152,000 optical frames, with a turnover of AUD$5 million. Most of the production occurs in China, where 90 per cent of the world's optical frames are currently manufactured, primarily for the US and European markets.

The BSL accepted ownership of the company on the basis that it would investigate the ethical implications of owning a company that sourced goods from China. Profits were quarantined for two years, and used to fund a thorough investigation of the supply chain, the conditions of the workers, and the barriers to improvements in these conditions and some creative responses to the issues. This has involved extensive discussions with factory owners in China and their representatives in Hong Kong, the Hong Kong Optical Manufacturers Association, brand name customers who use the same suppliers in China, NGOs based in Hong Kong and Australia such as the Asia Monitor Resource Centre (AMRC), Hong Kong Christian Industrial Committee (HKCIC) and Oxfam, academics, trade unions, industrial hygienists and representatives of organisations such as Business for Social Responsibility.

The experiences of the BSL in attempting to responsibly manage the supply chain of its commercial enterprise highlights the realities of FDI in China. It provides valuable insight into the complexity of the issue, and the opportunities and challenges facing those enterprises that are committed to sustainable business practices. The BSL has accepted responsibility for its investment via supply chains in China, and is looking beyond relying on codes of conduct and monitoring to demonstrate corporate responsibility and protection of workers rights. Its emphasis is on direct engagement with suppliers and the promotion of education and training as the most meaningful way to support labour rights and participation. The research confirms that no one organisation has all the answers to achieving sustainable FDI. The best results are achieved through innovative incremental progress and global collaboration amongst enterprises, trade unions, industry associations, NGOs and governments.

Mapping the Mod-Style supply chain

Identifying the factories

This has involved identifying and regularly visiting factories that supply Mod-Style, developing an understanding of the customer profile and subcontracting relationships of the factories, and understanding the workforce. The BSL has invested considerable time and resources to understand the business and labour rights issues in China – an undertaking which, whilst difficult for many small or medium enterprises, needs to be done to contribute to sustainable FDI. Mod-Style's largest Chinese supplier (also one of the largest producers for the global market) has 4500 workers, 20 production lines, and a monthly production capacity of 1.1 million optical frames. It is listed on the Hong Kong stock exchange and has a market value of more than US$50 million.[5] This company is setting standards that go beyond the requirements of many foreign enterprises, and helps demonstrate that not all production facilities in China are "sweatshops".

Mod-Style has approximately 10 suppliers in China, most of which are wholly Hong Kong owned family businesses, with the well-educated and business astute second generation significantly involved in managing the operations. Those factories with 1500 workers or more have clearly appropriated the benefits of FDI, adapted technologies and processes from Europe and Japan and created highly competitive operations in global markets. In other respects, however, it cannot be said that the Chinese workers have achieved “decent work”, in the sense understood by the ILO.

Companies pursuing sustainable FDI in China need to familiarise themselves with the different management practices of the countries that have established joint ventures or wholly owned production facilities in China. Regardless of the nationality or their particular management style, the emphasis should be on compliance with The Labour Law of the People’s Republic of China (PRC), 1994. Cultural differences in management styles and business practices do not justify differences or erosion of basic labour rights.

Customer profile and subcontracting relationships

Prior to China joining the World Trade Organisation (WTO), the Hong Kong owned optical factories based in China were producing only for the export market. At that time and now, the final customers include some of the large global brands; however, many of these larger customers have no idea which factories are producing their products or the conditions under which they are being made. They rely on complex licensing arrangements with trading houses and agents that do not necessarily share the stated values and business practices of the brand name company. This lack of transparency is, in some cases, a calculated risk management strategy to assist in ensuring minimal damage to companies’ reputation as result of potential labour rights and environmental concerns. It can also be interpreted as an enterprise not accepting its corporate responsibility for the global dimension of its business, or that China is complex and the less they know about it the better.

The size of the factory in China influences not only conditions but also the complexity of sub-contracting arrangements. The smaller factories often outsource production processes such as electroplating and injection moulding, and are not able to access the advantages of the larger vertically integrated operations. In addition, our research has shown that those factories that are able to produce cheaper products than their competitors, are doing so through compromising labour standards and the necessary investment in capital equipment and facilities that would ensure acceptable occupational health and safety standards.

Understanding the workforce

The workforce in the optical industry is representative of much of the manufacturing sector in southern China. The majority of workers are young women aged 17-25 years who have migrated from surrounding rural provinces to work in the burgeoning industrial districts. Their primary aim is to earn as much money as possible. Generally speaking, they appear to have a relatively low level of education, and for the most part are not well informed of their labour rights. Most are employed in repetitive, low-skilled jobs. Staff turnover is high, with most workers staying with a factory for one to two years.

Understanding the labour and environmental conditions

The BSL experience has shown that not all factories are the “sweatshops” often attributed to China. Factories and their processes vary in terms of conditions for workers, compliance with labour and environmental standards, and managerial style, as they do in Australia. For example, some factories meet their obligations and provide social security contributions on behalf of workers, but have a heavy security presence and an arbitrary system of fines and deductions. Other factories provide state-of-the- art facilities and architect-designed plants, yet expect excessive overtime without appropriate remuneration. In pursuing sustainable FDI, it is necessary to recognise that the physical conditions of a factory can be misleading and thereby divert attention from poor labour conditions. It is important to remember that currently all workers migrating from rural areas are in a vulnerable position because of their temporary residential and employment status resulting from the Chinese system of residential registration, or "Hukou". This system will need to be reformed if China is to continue to develop and meet the needs of its highly mobile labour market

Environmental standards and physical conditions

Environmental standards and physical conditions vary significantly among the factories in China. With regard to the optical industry, the larger factories, which undertake electroplating on site, had sophisticated equipment, ventilation and waste management. Indeed, worse conditions have been witnessed in Australian electroplating facilities. All factories appeared to collect, and in some cases treat, wastewater before it was sent to an outside plant for further processing. Some factories had acetate dust collection bags, and in one case all acetate shavings are sold for recycling into personal goods such as combs and toothbrushes. Chemicals and paints are, for the most part, well labelled and stored, and most of the larger factories had a chemical inventory. The smaller optical factories, however, did not appear to invest as heavily in the capital equipment and processes necessary to ensure compliance with environmental standards.

The physical conditions of the factories also presented a complex picture. Generally, they were better than anticipated, particularly in terms of occupational health and safety (OH&S) standards. Most of the factories visited were clean and well lit with adequate heating and cooling. Dust masks are often provided (though rarely worn), and some factories have specialised "hands-free" machines to reduce finger injuries. The overall impression, confirmed by Hong Kong based NGOs such as the Asia Monitor Resource Centre, is that these factories provide better facilities and working conditions than usually reported in the toy, footwear, textile and apparel industries, industries that are relatively well understood and accessible to independent monitors. The same cannot be said of the electronics and petrochemical industries in China which are very much off limits and where conditions are reported to be harsh.[6]

In other respects, however, it cannot be said that the Chinese workers have achieved "decent work", in the sense understood by the International Labour Organisation (ILO). For example, worker accommodation is often Spartan and dehumanising. In the worst cases limitations are placed on water usage and time allowed for toilet breaks. Large, clean new factories do not guarantee reasonable working conditions and can often mask serious human rights abuses.

Labour standards

Significant human and labour rights issues exist, particularly with regard to wages, hours, and social security entitlements. In these key areas there were evident breaches of The Labour Law of the PRC. Managerial regimes are strictly hierarchical and at times repressive. It is often difficult for workers to raise grievances and have disputes resolved without risking reprisal. Fines and disciplinary action are common, and in some factories workers appear despondent. The BSL experience has confirmed that overall workers are compliant and in reality do not participate in the co-determination of their workplaces in any meaningful way.

Freedom of association outside of the only legal trade union (All China Federation of Trade Unions – ACFTU) is not possible. Whilst some optical factories had trade union representatives, these positions are usually held by supervisors and managers. There was no evidence of collective bargaining, and conditions were set by unilateral management decisions.

Consideration will need to be given to the issue of freedom of association and collective bargaining if discussions and progress on the complex issue of human rights and business is to be progressed. In this regard, individual firms have little ability to bring about change in China, as this is a matter of national law. However, it should be noted that several of the major footwear companies have been involved in a significant capacity building project which is encouraging worker participation through occupational health and safety committees.[7] Furthermore, one of these companies has been involved in facilitating ACFTU elections within a factory, a significant first step in the process of ensuring workers' participation in choosing their union representative. These examples help demonstrate that progress is taking place in China, often at an astonishing rate and there is scope for enterprises to contribute.

Foreign direct investment in China – understanding the issues, opportunities and limitations

The regulatory, business and cultural environment

China's Labour Law and regulatory environment

China has a complex regulatory environment that needs to be understood in the context of sustainable FDI. Chinese labour law sets standards and rules,[8] which are as high as those in most OECD countries, although the extent to which they are implemented and influence behaviour in the factories is another matter. There is a gap between practise stated by Department of Labour and ACFTU officials and some foreign enterprises and factory managers, and what actually occurs.

The Chinese legal system and culture do not provide strong institutional support for compliance with domestic law, and there are many inconsistencies within the laws and regulations. Chinese labour law is complex, made more so by provincial adaptations and exceptions in special economic zones. Some factory managers have expressed frustration about the complexity of the regulations (and also the foreign company imposed codes of conduct) and the inability of the local departments of labour to assist with interpretation of the law. Local labour departments may prefer not to insist on compliance with laws – it is reported that staff have friends and relatives who manage factories, and financial contributions and kickbacks are a reality.

Workers are not well informed of their rights, and the weakness of Chinese legal institutions means too that workers are reluctant to take steps to secure their legal entitlements, adding to a culture of avoidance of legislated standards. China is not a country with a strong civil society. The trade unions are not particularly effective in protecting workers rights, independent NGOs have very little space in which to operate and there are few consumer protection mechanisms. As such, factories are under no pressure from Chinese society to reform and comply with labour law, thereby adding to an environment that misses opportunities to maximise the benefits of FDI. This is most evident with regard to wages, hours of work, social security entitlements and overtime. The practices of not paying legal minimum wages, appropriate overtime and bonus payments, and of imposing arbitrary fines and deductions force many workers to choose a factory where they are able to work illegal amounts of overtime in order to survive. Interestingly, in the optical industry many factory managers are now openly saying they cannot comply with the legal hours of work. One view is that NGOs should accept this and campaign to ensure workers receive the appropriate wages for hours and overtime worked. However, this does not address the issue of industrial accidents and work-related deaths caused by excessive overtime.[9]

The key to reform in China is collective bargaining and an increase in employee autonomy. China has a variety of collective contracts but these do not touch on the subject of collective disputes. In this regard trade union reform is needed, to ensure that representatives are democratically elected, professional and represent the workers concerns.[10]

These are complex issues of national scope, and there is very little a small firm can do to ensure the guaranteed, full enforcement of all laws. There are however, opportunities to contribute to sustainable FDI and these are discussed later.

Codes of conduct, monitoring and compliance

In addition to the national laws, there are various requirements of large customers, in the form of corporate codes of conduct or certification with reporting instruments such as SA 8000. Whilst important in contributing to the promotion of core labour standards (particularly where national laws are inadequate or poorly regulated), in our experience, codes too often represent a shallow attempt to understand the real difficulties in trans-national supply chain management. They do not provide an accurate representation of conditions. They are often developed at distance with a lack of involvement and commitment from both workers and managers. They are frequently poorly promoted and understood within factories, and workers are usually not consulted or given an opportunity to comment freely and without reprisal on their operation. Monitoring, compliance and enforcement is complex and problematic, and inspections are ad hoc and not necessarily undertaken by skilled personnel able to accurately identify falsified information. In addition, some codes are insensitive to local laws and customs and ignore the reality of Chinese labour relations by claiming that the principle of freedom of association is adhered to.

The proliferation of corporate codes of conduct does detract from a factory's capacity to comply with the Labour Law of the PRC. In isolation, codes cannot be relied on to protect workers' rights or promote worker empowerment, nor should they be seen as an alternative to national labour laws. Codes of conduct are, however, a useful first step in harnessing an enterprise's commitment to promoting sustainable FDI. What may be of greater value is a code of ethics or similar document that goes beyond regulations and compliance, and captures the spirit or organisational culture and willingness to progress corporate responsibility.

Sustainable FDI and competitive advantages

The BSL's experience in China has confirmed that some factory managers are increasingly interested in how a business can be both ethical and competitive, particularly in sectors such as the optical industry, which are highly competitive. There is increasing awareness that corporate responsibility and improved compliance with both corporate codes and national laws could be turned into a competitive advantage. Improved compliance is already resulting in certain factories being more desirable to large brand name customers, and could be used by those companies to bolster their reputation as an organisation committed to sustainable FDI. This situation provides benefits for the factory through increased production contracts, benefits for the enterprise that is investing in the factory through improved supply chain management and corporate responsibility, and benefits for the factory workers who enjoy improved labour conditions. This is an area that deserves considerable attention, and foreign enterprises have significant scope to pursue innovative mechanisms based on this concept. Investigation of the competitive advantages that flow from sustainable FDI could be a more meaningful approach to protecting workers rights amongst trans-national supply chains.

Opportunities for enterprises to support sustainable FDI

How can companies ensure their impact is positive?

Enterprises have a significant role to play in ensuring that FDI is sustainable and that the benefits are more evenly distributed throughout society. Supply chain management and offshore trading relationships are an important part of ensuring an organisation has a consistent approach to corporate responsibility that recognises the global dimensions. For example, an organisation cannot claim to be pursuing ethical business practices based on a code of conduct, without giving consideration to the labour and environmental practices amongst supply chains abroad. This is particularly important in a developing country that may have a weaker regulatory environment. In addition, those companies that pursue ethical business practices abroad are well placed to appropriate the competitive advantages that flow from sustainable business and contribute to FDI for development.

There is no one answer or quick fix remedy to ensure sustainable FDI amongst supply chains. What is required is a variety of responses that have been customised to suit the needs of all stakeholders and the business and regulatory environment offshore, and the size of the enterprise in which investment occurs. No one approach is completely right or wrong, however compliance with universal treaties and national laws to uphold basic labour rights and environmental standards should be the non-negotiable starting point. How enterprises then apply these conventions and statements, many of which are addressed to States, is the real challenge. It is necessary for an enterprise to then translate these principles into a form that can be applied in individual workplaces. This could include an emphasis on governance and SRI (particularly for publicly listed companies), improved compliance with local law, occupational health and safety, education and training programs for workers and managers etc. All these undertakings contribute to the necessary incremental and progressive steps that will contribute to sustainable FDI and a more even distribution of the benefits.

Stakeholder dialogue: opportunities for enterprises – the BSL Model of Engagement

China’s astonishing capacity to change and develop provides an important backdrop against which to address the issue of sustainable FDI. It means that the opportunities for stakeholder dialogue are significant, and enterprises, both large and small have a role to play in contributing to discussion and promoting the development value in sustainable ethical business practices and investment.

Enterprises and factories in China do not yet have well developed communication systems and processes. This means valuable opportunities to communicate with workers, NGOs and other external players are not being taken up. The BSL has developed a Model of Engagement, a creative response to the complex issue of supply chain management. It involves undertaking research, the establishment of stakeholder dialogue and building long-term meaningful relationships with contractors and suppliers to discuss innovative ways to improve supply chain management and protect workers’ rights.

The Model of Engagement promotes education and training as the most appropriate mechanism to encourage worker empowerment and self-determination, and to the development of sustainable improvements to labour and environmental standards. It is, in effect, a mechanism that surpasses the use of codes of conduct and monitoring mechanisms.

This Model is a dynamic process that requires a commitment to continuous dialogue and establishing partnerships and alliances with all stakeholders. The BSL has adopted a non-confrontational approach in discussions with factories. This supports the view that the most useful first step is to engage directly with workers in some way that benefits them and which will be acceptable to the local management. This latter qualification is essential to have any hope of success.

To this end, the BSL is pursuing a number of innovative strategies, all of which involve global collaboration with brand name customers, NGOs and other key stakeholders. A series of factory-based workshops are being planned. These will build on the existing education and training that is currently being provided by a global brand. Discussions are under way to investigate opportunities for small and large enterprises to work together in shared factories in a way that allows each to benefit from the purchasing power of the global brand, and the production and industry knowledge of Mod-Style. An occupational health and safety (OH&S) needs assessment involving workers, managers and external technical expertise is also being considered.

The checklist below may assist organisations that are committed to sustainable FDI within a framework of social responsibility. It is by no means exhaustive, and the inherent risks associated with checklists in terms of omitting important issues and narrowing the complexity of the debate must be recognised. It may, however, provide new ways of thinking to assist organisations in ensuring ethical business practices are embedded in the corporate culture and are factored into FDI decisions.

Improved corporate responsibility and sustainable FDI in China: a checklist

Acknowledge that the organisation's corporate responsibility includes its global activities, including supply chains and subcontracting relationships and ensure this is included in any triple bottom line reports.

Undertake research and allocate resources to ensure social responsibility and sustainability is an ongoing component of international trade and investment.

Understand and map all supply chains and subcontracting arrangements.

Visit factories and workplaces regularly and continue to discuss issues of corporate responsibility and sustainable FDI.

Develop non-confrontational ways of communicating with factory managers.

Understand the labour, environmental conditions and regulatory framework in the countries of operation.

Respond to the central government's current regulatory emphasis on OH&S and other efforts to improve workplace conditions.

Develop open, transparent and direct long-term relationships with suppliers rather than relying on "arms length" contracting and licensing agreements.

Develop joint venture and other business contracts that incorporate criteria for sustainable FDI and corporate responsibility – this is currently particularly important in the electronics and petrochemical industries in China.

Invest in capacity building offshore, including education and training for workers and managers, and the promotion of ethical business practices.

Avoid the attraction of searching for the cheapest labour and goods, at the expense of social and environmental responsibility and sustainability.

Commit time and resources to understanding the business environment and culture of the countries of operation and be prepared to employ specialist staff.

Recognise that corporate responsibility becomes more complex as trans-national activity increases.

Recognise that a Code of conduct and monitoring does not provide all the answers or protect workers rights.

Improved corporate responsibility and sustainable FDI in China: a checklist *(cont.)*

Recognise the limitations and opportunities facing enterprises seeking to contribute to sustainable FDI – incremental progress based on a commitment to action is worthwhile.

Develop alliances and partnerships with NGOs, worker representatives, academics, other enterprises and government representatives to contribute to corporate and social responsibility through global collaboration.

Commit to and act in accordance with the appropriate international treaties, conventions and guidelines – particularly the OECD Guidelines for Multinational Enterprises, in all dimensions of the business.

Document your experiences in managing supply chains offshore, both the good and the bad, and make this information available to others, including Chinese officials who will welcome feedback on how to continue to attract FDI.

Encourage your industry association or professional body to engage with the issue of sustainable FDI and develop an industry wide strategy and plan of commitment for incremental improvement.

Contribute to consumer education and campaigns – assist consumers to make informed choice based on a clear understanding of where goods are produced and investments made, this could include labelling.

Limitations to enterprise capacity

Core labour standards

The core labour standards themselves create limitations to an enterprises' capacity to influence sustainable FDI. Core labour standards are "big picture" issues addressed to States and it is all the more difficult for enterprises to support compliance as many factory managers in China – and indeed, in many developed countries – do not see the links between labour rights and human rights, environmental standards and social justice.

Complexity of the issue: conceptual and ethical considerations

It is important to recognise that corporate responsibility amongst supply chains is a very complex issue. The conceptual and ethical task of dealing with Chinese factories is difficult for the small firm, even one committed to operating in an ethical manner. It requires time, resources and commitment. Specialist staff is needed with expertise and knowledge of the labour and environmental issues and regulatory environment of developing countries.

To demonstrate this complexity, the BSL has recognised that there are no easy answers to the difficult questions raised by our work. For example:

- What is the best approach to ensure sustainability and an enduring culture of corporate responsibility amongst our supply chains? Can this realistically be achieved?

- Do we only deal with factories that are open to our approach of continuous improvement and withdraw from dealing with the bad ones?

- To what extent can we accept willingness to change as a basis for an ongoing relationship with a supplier, irrespective of the time frames for achieving real change?

- How do we determine the point at which conditions are just so bad that nothing is to be gained by our continued involvement with that factory?

- How do we honour the ILO principles to which we are committed where they are simply impossible to enforce in the non-complying State?

- In which areas should we concentrate our efforts in terms of improved compliance – wages, hours, social security entitlements or the less threatening area of occupational health and safety – and who should make this decision?

- Would dealing with fewer suppliers increase the capacity to bring about an improvement in individual factory conditions as production increases?

Complexity of the law and ineffective regulation

The existence of a system of law that ensures compliance is essential to protect workers rights. However, the complexity of the Chinese legal system is, in itself, a limitation to enterprises pursuing sustainable FDI. Chinese labour law, whilst reasonably progressive, is diminished as a result of poor implementation and enforcement. Enterprises interested in investing in China need to work within the regulatory environment as best they can, and where possible, contribute to dialogue concerning simplification of the law. Enterprises need to become familiar with the Labour Law of the PRC and then make decisions about where they stand on issues such as wages, hours, access to social security entitlements, OH&S, freedom of association, collective bargaining, and the role of the ACFTU. They need to determine criteria by which they will assess FDI in terms of the social, environmental and economic impact. This requires a good understanding of the working and living conditions amongst the supply chains, opportunities to improve those conditions and mechanisms to monitor compliance. The prospect of such an undertaking can in itself be a limitation for enterprises.

Costs of compliance

In highly competitive industries, product cost and relationships are often the only differentiating factor. Improved compliance means operating costs will escalate and lead to higher unit costs for customers. The failure of enforcement and tight competition means that managers believe they cannot afford to comply with local laws in the absence of any guarantee that competitors will also do so. There is a fear of losing customers to less compliant factories, or even to other countries such as Vietnam and Indonesia where labour is even cheaper and more compliant, and the regulatory environment less well developed. In this regard, foreign enterprises have a responsibility to ensure production is not moved from factory to factory in search of the cheapest labour and least rigorous standards, and that improved corporate responsibility amongst supply chains does involve some costs but many more benefits in terms of sustainable business practice.

Customer leverage

The reality for many small or medium enterprises is that, on their own, they have limited influence. Even those enterprises such as Mod-Style with the best intentions and enterprise commitment to core labour standards, have limits on what they can do as a result of their relatively small production. However, factory managers have, for the most part, appreciated the Mod-Style approach of direct dialogue to pursue corporate responsibility rather than arms length directives and threats to cut production. Currently, large enterprises need to lead the way in terms of sustainable FDI in China, however the total number of small to medium enterprises investing in China is significant and this needs to be harnessed through global collaboration and industry-led initiatives.

Corporate governance and production networks

A further limitation for enterprises is the difficulties they can encounter in navigating global production networks that are often a maze of licensing arrangements shrouded in secrecy. Trading houses are responsible for managing the production of various products in China, yet many are unwilling to acknowledge that they are being made in China. This lack of transparency and accountability hinders efforts to promote sustainable FDI. Too often, poor transparency and corporate governance is defended under the guise of commercial confidentiality. In this regard it is important to recognise that these global production networks that can be a limitation to sustainable FDI.

Industry associations

Industry associations and professional bodies can be another limitation on enterprises' ability to influence FDI for development. They do not prevent enterprises from exerting influence, but they do not encourage corporate governance and transparency either. For the most part, they are primarily interested in developing new markets, sourcing new production techniques and meeting industry specific requirements. Protecting workers rights and environmental standards in China is not a high priority for these organisations.

The OECD Guidelines for Multinational Enterprises and supply chain management in China

Implementation of the OECD Guidelines for Multinational Enterprises (Guidelines) in non-adhering countries such as China is problematic; however opportunities do exist for enterprises to pursue sustainable FDI. There is little doubt that complex subcontracting and supply chain arrangements make application of the Guidelines more complex, however, there is a role for home governments in supporting those enterprises seeking to do the right thing. Assistance can be provided to firms, particularly small and medium sized enterprises, through ensuring they understand the realities of sustainable and socially responsible investment in developing countries. This requires governments to make the connections between human rights and international business, and to accept some responsibility for the business activities of enterprises abroad to contribute to compliance with labour and environmental standards. Enterprises need to be persuaded to improve their transparency and accountability, particularly regarding their global production networks, licensing arrangements and portfolio investments. This will require giving up the current emphasis on "confidentiality", which is often presented as a commercial imperative, but can be also be interpreted as a calculated risk management strategy to reduce perceived negative consumer or shareholder backlash. Similarly, the contractual relationships along supply chains could be disclosed, for example, in annual reports of firms. This is consistent with the Guidelines in terms of disclosure.

Maximising the benefits of existing responsibility regimes

The Guidelines are currently the highest set of standards available amongst the global corporate, social and environmental responsibility regimes that can contribute to sustainable societies. They are the most important code of conduct that exists for business, and allow opportunities for citizens to raise concerns about the practices of international companies with the home government.[11] In conjunction with the Global Reporting Initiative (GRI), there is significant scope for enterprises to contribute to sustainable FDI in a manner that becomes increasing comparative and useful in contributing to socially responsible business practices. There are, however, still significant implementation issues that remain a barrier to their potential success.

Implementation – the case for improved transparency

Considerable work needs to occur to bolster the OECD Guidelines in the area of implementation and verification, and NGOs and trade unions are well placed to do this. In addition, the OECD member State National Contact Points (NCPs) have a responsibility in terms of better promotion of the Guidelines and ensuring that when cases are raised the process of investigation and progress is transparent, accountable and speedy. NCPs need to do more than just support the Guidelines in principle or until they cause "discomfort", a reality given that many NCPs are government officials who work closely with the private sector securing investment at home and abroad.[12] A central registry of cases that have been presented to NCPs is required, as are more detailed NCP annual reports with information on the cases that have been raised and the companies involved.[13] This would go some way to addressing the concerns of many NGOs that the Guidelines fail to empower affected communities and are limited in their effectiveness because they are not binding or enforceable. The issue of improved transparency and accountability needs further consideration if the Guidelines are to contribute to sustainable corporate responsibility in a meaningful way, and to achieve uniform respect from all stakeholders – NGOs, TUAC, BIAC and the OECD and adhering country representatives.

Integrated trade and investment

The OECD Guidelines, whilst not binding, do commit OECD member States to active participation in the corporate responsibility debate and practice. This requires Governments to respond to the increased global integration of trade and investment and to ensure policies aimed at corporations are in keeping with the OECD Guidelines. Incentive packages, such as subsidies and export credit regimes, designed to both attract inward investment and promote external investment, both trade and portfolio, need to be consistent with the OECD Guidelines.[14] Negotiating global rules for investment is undoubtedly high on the agenda of the OECD Committee on Investment and Multinational Enterprise (CIME). The business community is seeking increased access to foreign markets through direct investment (Greenfield), mergers and acquisitions, privatisation, portfolio investment, financial services and global production networks. In addition, they are applying pressure to CIME to encourage developing countries to accept more liberal investment regimes.[15]

At the OECD Roundtable on Corporate responsibility[16] it was claimed that supply chain issues were outside the scope of the Guidelines and that trade and investment should be considered separately. Such a position does not acknowledge the explicit references to "suppliers and sub-contractors"[17] in the text, which clearly recognises the global integration of trade and investment and the mandate to include supply chain and subcontracting relationships within the scope of the Guidelines. Efforts to separate trade and investment and supply chain management, and thereby dilute the potential of the OECD Guidelines, should be discouraged. If this is not done it will further increase the scepticism of some NGOs and trade union groups as to the Guidelines effectiveness.

Conclusions

China's astonishing capacity to change and develop provides an important backdrop against which to address the issue of sustainable FDI. It means that the opportunities for stakeholder dialogue are significant, and enterprises, both large and small have a role to play in contributing to discussion and promoting the development value in sustainable, ethical business practices and investment. The BSL experience, and the contribution of many other organisations such as the Northern Alliance for Sustainability (ANPED), TUAC and the Asia Monitor Resource Centre (AMRC) to name a few, as well as the progressive enterprises, clearly demonstrates that there is no one solution to ensure sustainable FDI, particularly in developing countries.

What is required is a variety of innovative responses that suit the needs of all stakeholders and that are based on internationally recognised principles that contribute to the protection of labour rights and environmental sustainability. This is best achieved through alliances and partnerships between business, NGOs, trade unions and governments. The OECD Guidelines for Multinational Enterprises in conjunction with the GRI are currently the best placed corporate responsibility mechanisms, and with additional attention to the issues of implementation, monitoring and improved transparency could be a powerful tool.

Trade and investment are clearly integrated in the global economy and greater attention needs to be given to the complex area of corporate responsibility amongst supply chains and subcontracting arrangements. The experience of the BSL with its optical enterprise firmly entrenched in China clearly demonstrates that it is possible for small enterprises to contribute to the global debate and practice if there is a strong commitment and willingness to invest in ethical and sustainable business practices.

NOTES

1. For further information on this paper or the ongoing work of the Brotherhood of St Laurence, please contact Serena Lillywhite, Manager, Ethical Business (slillywhite@bsl.org.au) or visit the website: www.bsl.org.au.

2. This paper is based on research undertaken by the Brotherhood of St Laurence, some of which has been presented at the OECD Roundtable on Corporate Responsibility in Paris, June 2002 (Lillywhite, S., 2002 (in press), *Pursuing corporate responsibility in China – experiences of a small enterprise in the optical industry)*; and at the Academic Meeting on International Labour Standards and Workers' Rights, and Business and Human Rights in Wuhan, China, October 2002 (Lillywhite, S., 2002 (unpublished), *Pursuing corporate responsibility in China – labour rights and supply chain management.* Paper presented to the Academic Meeting on International Labour Standards and Workers' Rights, and Business and Human Rights in Wuhan, China, October 2002).

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CREATING EFFICIENT NETWORKING AND EFFECTIVE LINKAGES IN INVESTMENT PROMOTION

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Background

The role of Foreign Direct Investment (FDI), as an accelerator of development – especially in the growth of the industrial sector, – is generally accepted and the empirical evidence supports this view.[1]

The principal manifestation of this acceleration is in terms of externalities (managerial, productivity and technological spillovers) from FDI that occur at the inter-organisational interfaces between foreign investors and host (local) suppliers, joint venture and strategic alliance partners, as well as in other collaborative forms of international business. However, the efficient capture of externalities is not a certainty. Strategies need to be designed and institutional structures established and operated effectively by relevant authoritative agencies in the host economy to ensure the efficient capture of evolving externalities from FDI. It goes without saying that the FDI in question would be attracted by the host precisely because of the type and quality of the externalities. From UNIDO's perspective there are effective ways and means for developing countries and their enterprises to attract FDI for development and benefit more competitively from the investment, in part by capturing externalities.

Introduction

The issues in managing to attract FDI and capture fully its beneficial spillovers are complex. The examples of newly industrialising economies show there are no simple unilateral solutions. Action is required at many levels. Policy instruments need to be fine tuned and a carefully worked out strategy needs to be in place fin order to reap the potential benefits of FDI flows.

Challenges facing policy makers, development strategists and investment promotion practitioners are rising in concert with dynamic changes that are taking place on one hand within the evolution of the integrated international sourcing, technology, production, distribution and marketing of goods and services,[2] and on the other hand within the spatial distribution of the world's leading multi-national enterprises (MNEs) and their collaborative investment relations.[3]

An examination of the statistics on global FDI flows annually, compiled from the International Finance Statistics for UNIDO's classification of countries, confirms persistence of the asymmetric distribution of FDI between developing and industrialised countries on the one hand and within the developing countries on the other hand. The least developed countries (LDCs) and many countries in Africa are by-passed by FDI flows. This contributes to their industrial marginalisation. Marginalisation in turn prevents their economies intermediating meaningfully, with attendant advantages, in the current process of globalisation of production. This is in sharp contrast to the widely acknowledged range of socio-economic and managerial benefits that FDI can bring to a host country (capital and technology inflows, employment creation, income generation, as well as management skills and organisational know-how).[4] The combination of attracting FDI, capturing externalities and promoting investment is therefore not an end in itself. It must be viewed strategically in the wider context of the contribution of FDI to a country's overall industrial development and competitiveness.

Issues and Challenges

There is a growing consensus that, given the rule-based world trading system, an increasingly deregulated and liberal FDI regime hallmarked by well-calibrated modal neutrality, market contestability and policy coherence is a necessary, but not sufficient, condition to attract, and benefit from, foreign investment into a country. Sound macro-economic fundamentals and micro-economic reforms of the business environment are prerequisites for a country to maintain its place on the international investor's map. Additionally, creating and maintaining effective support institutions – that is, investment promotion agencies (IPAs) – are likely to remain crucial factors for sustaining the investment cycle. The investment cycle is seen by UNIDO as an interactive dynamic "virtuous" feedback process comprising: needs assessment for servicing existing investors; FDI road-mapping to remove administrative obstacles and managerial impediments to FDI; investment promotion and institutional capacity-building to attract FDI; supporting the creation of local and international backward and forward production and marketing linkages; and performance review for improved servicing of new and existing investors. Furthermore, country image-building and investment destination marketing efforts will remain crucially important to the long-term strategic process. From UNIDO's experience the sufficient condition, on the part of developing country IPAs for overall successful investment promotion efforts, is a pronounced emphasis on the pro-active and targeted promotion of specific investment opportunities.

A brief explanation is apposite before highlighting the different dimensions of creating efficient networking and effective linkages in investment promotion. In the present evolving circumstances of globalisation of production, the factors that determine FDI location decisions have grown in complexity. Traditional FDI motivations, such as a country's natural resource base, its market size, or the availability of low-cost labour while still valid, are losing importance in the evaluation by, and decision-making of, MNEs. Due to rapid technological advances, convergence of information communications technologies and new managerial techniques, profound changes are underway in the micro-economics of the industrial organisation of manufacturing and production processes. These changes – encapsulated by the economic geography of production, the spatial distribution and managerial co-ordination of international stages of manufacturing – have an increasing impact on the investment location decisions and operations of MNEs and the way in which MNEs interact with other enterprises particularly host local firms.[5]

At the host country level, the availability of production factors of the kind and quality needed for linking up to, and integrating with, international value chains [which in turn have multiple subcontracting and original equipment manufacturing (OEM) relationships] assumes growing importance. The major implication of all this is that national policies should be cognisant of the governance structures of international production, and therefore policy makers should design incentive structures that lock into selected links of the distributed value-chains and geographically specialised manufacturing operations of MNEs.

In other words, whether or not developing countries can engage with MNEs production networks depends very much on the level of development of specific parts of their industries. In order to link into these international value chains, developing country companies have to be increasingly internationally competitive within particular niches. Clearly, this requires that developing countries direct their attention beyond the confines of "traditional" investment promotion policies and activities. They need to improve design and articulation of the investment cycle in conjunction with quality, standards and metrology-related policies; policies on the promotion of (and internationalisation of) small and medium-sized enterprises (SMEs); and technology and innovation policies. Several key publications including UNIDO’s Industrial Development Report 2002/2003 emphasise that promoting linkages takes us to the nexus of investment and SME policies.

UNIDO publications *inter alia* the Industrial Development Report 2002/2003[6] address the critical importance of innovation and learning to improve the competitive performance of a country’s industrial sector. This particular report identifies points of engagement with the international system of production for increasing industrial competitiveness through the upgrading of national learning and innovation systems. The report introduces the Competitive Industrial Performance (CIP) Index as a benchmark for comparing industrial performance and ranks 87 countries.

FDI is one of five key drivers of industrial performance – in addition to local technological effort, skill development, licensing and quality of infrastructure – analysed in the report and found to play a central role in developing competitiveness, particularly for industries manufacturing market dynamic products.[7] The UNIDO report's findings raise issues concerning, *inter alia,* the usefulness of promoting relatively low technology industries, such as labour intensive textiles over the longer term.

What else does the UNIDO Report imply for the future work of attracting increasingly higher level manufacturing value-added FDI by developing country IPAs? General conclusions that may be drawn are that, firstly in order to better support their country’s FDI policy regime and regulatory framework, IPAs need to develop acute institutional awareness of the underlying structural changes in world production systems as articulated by international investment and technology flows. Secondly, capacities have to be built up, or strengthened, for researching, monitoring and informed assessment of evolving technological and organisational patterns in manufacturing in general and within priority sectors in particular. The objective is to identify points at which links between local industry and foreign companies can be created. IPAs should do this in concert with other institutions in the country to define needs and take action in co-ordinated strategic and practical steps to meet this objective. Thirdly, as empirical evidence[8] suggests, IPAs are isolated from the dialogue and networking communication exchange between existing investors and new investors. Only in a small number of cases do new investors benefit from dialogue, regarding investment opportunities, with IPAs. Therefore, the need for IPAs to network more intensely with existing investors and other players in the business support system, such as business associations, Chambers of Commerce and Industry, SMEs development agencies, export promotion bodies, R&D and technology institutes cannot be overemphasised in the overall strategy to attract and benefit from FDI.

More specifically, one increasingly effective way for IPAs to support the creation of backward and forward linkages between domestic and foreign enterprises is to get involved – directly by brokering – in the process of matchmaking between complementary enterprises through subcontracting, OEM and supply relations. It is accepted that the availability of a local network of reliable and capable suppliers and subcontractors is a strong motivation for FDI especially that which is export oriented.

UNIDO has gained considerable practical experience in this field from its enabling services for managing Industrial Subcontracting and Supply Chain Development. The programme has yielded valuable lessons of experience. Industrial subcontracting between firms of different capabilities, types and sizes, especially between large and small enterprises, is a defining characteristic of modern intermediation in industrial economy. In industrialised countries, and in agglomerated markets, an intricate and spatially extensive network of complementary inter- and intra-firm production relations exists. Large corporations rely on smaller enterprises for the manufacture of parts, components and sub-assemblies, or for certain processing, transforming and finishing operations. Due to dynamics in production costs, subcontracting is recognised as an efficient way to increase the rate of utilisation of installed industrial capacities, to increase both production and employment in the SME sector, to produce better quality products at reduced cost, and thus to contribute to integration and national growth.

The objectives of the UNIDO Programme of enabling services, therefore, include reinforcing the capacity of local SMEs to engage in international production by increasing production (and thereby employment), upgrading technological processes and products, improving their international competitiveness, attracting equity participation and FDI, and promoting exports of manufactured products through linkages with the marketing networks of MNEs.

The key role in this matchmaking is played by the UNIDO Subcontracting and Partnership Exchanges (SPXs). To date, more than 60 SPXs have been set up with UNIDO's assistance in more than 30 countries. SPXs act as technical information, promotion and matchmaking centres for industrial subcontracting, OEM and partnerships between main contractors, suppliers and subcontractors. Together, they form the UNIDO SPX Network with links to more than 100 associated members. This SPX Network provides detailed standardised, updated and certified data on approximately 20,000 manufacturing companies worldwide.

UNIDO provides technical assistance for the set-up and operation of the SPXs, based on a standard approach and methodology. UNIDO recommends legal statutes and standard terms of reference for the establishment of autonomous SPXs, ideally as not-for-profit industrial associations run by qualified managers and engineers under Management Boards. For the operation of an SPX, UNIDO has developed a comprehensive methodology and support tools, known as the UNIDOSS (UNIDO Subcontracting System). These include database management software, called "Outsourcing 200", which is provided under a licence agreement.

The scope of enabling services provided by SPXs has been expanding to improve their role as supply chain management and development centres. In addition, SPXs organise "Supply Development and Upgrading Programmes" for clusters of small-scale suppliers and subcontractors to assist them in meeting the higher resolution quality requirements of major international contractors and buyers.

The available performance surveys conducted in 1993 and 1997 show substantial traffic between SPXs and their respective registered companies. In 1997, two thirds of the companies concluded at least one contract because of SPX intervention.[9] It needs to be recalled that some SPXs focus more on high-tech activities while others concentrate on high volume contracts with foreign companies, and still others facilitate smaller subcontracts.

The reason for dwelling at some length on UNIDO's Industrial Subcontracting and Supply Chain Management Programme is to inform the discussion on IPAs and their need to maximise benefits from FDI with respect to networking and linkages.

Responses

In relation to developing networking and building linkages for increasing effectiveness in investment promotion and attracting FDI, UNIDO has embarked on three new major initiatives. The *first* is the launch of the UNIDO-Africa Investment Promotion Agency Network (AFRIPANET)[10] in November 2001 and its associated survey of investor perceptions in Africa.[11] This Network functions as a resource group for agencies with whom UNIDO has worked extensively in country-level programme activities. It also provides a permanent platform for training as well as continuous linkage between member IPAs and UNIDO Investment and Technology Promotion Offices (ITPOs).[12] And finally, it provides a feedback mechanism to guide UNIDO in adapting its enabling services to the changing dynamics of FDI and evolving needs of developing countries.

The overall objective of the Network is to bring permanence to the partnerships between the IPAs and UNIDO. The substantive focus is placed on the further development of tools and methodologies as well as deploying strategies for investment promotion that reflect the resources available to African IPAs. These resources are limited and typically below the levels of the "IPA success stories" in the developed and advanced developing countries often exemplified as best practice. The AFRIPANET Inaugural Meeting started network discussions to explore practical, low-cost schemes that could be more readily applied in member IPAs. The Investor Perceptions Survey[13] conducted in four member countries (Ethiopia, Nigeria, Tanzania, Uganda) prior to the launch formed the basis for discussion. The surveys yielded valuable insights, in particular, concerning the utility of IPAs and, encouragingly, the high degree of reinvestment intentions of existing investors. Also useful was subsequent analyses that disclosed the significance of relationships between business sectors, investment intentions and incentives. Empirical evidence[14] suggests that not all IPA services are significant to investors. Those that are significant fall into two distinct factor categories: cost reducing incentives and specific information services. The latter is differentiated into: markets and industries, specific economic intelligence, import and export advice, and corporate advice.

IPAs therefore need firstly to restructure their organisations to focus attention on these services that investors want. Secondly, they need to make better use of information services in order to engage in the dialogue between existing and new investors. Clearly, catering more attentively to the needs of existing investors is a worthwhile, low-cost approach for the respective agencies.

The *second* initiative UNIDO has taken recently in pursuance of improved networking for investment promotion is "UNIDO Exchange". This is an electronic platform, designed to link the Organisation's various promotional networks together and help increase their reach to the community of industrial development agents. The UNIDO network of ITPOs is a core group of the Exchange. UNIDO ITPOs are presently located in 13 capital-exporting countries. Their primary objective is to promote investment opportunities from developing countries within the business community of their respective host countries. UNIDO Exchange offers on-line access to a virtual marketplace for screened investment project and partnership proposals, technology offers and requests. It allows liaison between industrial institutions and operators for concluding partnership agreements, and it provides an interactive access to UNIDO services, tools and methodologies.

The *third* initiative is a pilot activity in Nigeria, for eventual application regionally, which UNIDO is undertaking to improve access of local SMEs to equity finance through a Nigeria-based equity fund, set up by African Capital Alliance. The fund will operate on a fully commercial basis and as such will prefer a small number of large projects to many small ones. UNIDO is establishing a complementary SME Support Fund that will finance technical and business advisory services – both pre-investment and post-investment – to SMEs benefiting from the equity fund. Joint Ventures with foreign investors that provide technical know-how or market access are of priority interest to the equity fund. It is this aspect that may motivate IPAs towards a stronger involvement in the attraction of institutional investors and venture capital into their countries, given convergences in FDI and Foreign Portfolio Investment.

Conclusion and Policy Options

The challenges which all countries, especially some developing countries, face firstly in attracting more FDI flows, and secondly in benefiting from externalities, are enormous.

From a strategic perspective, a key part of the solution for the host country is to increase the "absorptive and intermediation capacity" of the industrial sector for investment and production partnerships with foreign firms. While this includes technological upgrading and improved competitiveness as continuing tasks, in UNIDO's view, the crucial policy position is for developing country IPAs to start addressing realistically the issue of linking domestic industries with international production systems.

In broad terms, three interrelated factors influence a country's ability to win FDI, and reinforce linkages and their spillovers:

- The overall coherence of national investment policy framework, public governance, and business and market competitiveness environment.

- The national investment cycle promotion and institutional capacity-building strategies.

- The national institutional capacity for implementing these strategies.

The relative importance of each factor varies by country and in time in relation to the country's developmental strategy, regulatory and institutional structures for supporting the efficient working of markets. The policy environment is of paramount importance in a country with a sizeable local market and substantial natural resources. For countries with smaller markets and fewer natural resources, an active and focused investment promotion strategy is important, as is having an efficient and effective IPA to implement the strategy.

In creating networks and linkages, an investment promotion strategy would need to involve the organised use of a range of promotional activities to enhance the capacity of a country to absorb FDI and overtime to increase the level of investment and intensify backward and forward production links. Most strategies use four different but interrelated sets of activities with varied emphasis depending on changing conditions. They are: activities to service existing, prospective and new investors (investor servicing); procedures aimed at identifying and removing administrative obstacles and managerial impediments to FDI; campaigns to enhance the image of a country (image building); and actions to generate an increased flow of investor's projects (investment generation). The importance attached to different variables in each of these activities varies by country and over time, but at any given time most strategies include elements of all four activities to create the most prominent network effects.

Investor servicing involves pre-approval services, approval services and post-approval services to existing, prospective and new investors. The key issue in investor servicing is policy effectiveness in reducing uncertainty for the investor.

Identifying and removing administrative obstacles and managerial impediments require sophisticated analytical techniques and subsequent management and legislative policy responses. Using FDI "road-mapping" to identify the administrative obstacles and managerial impediments is effective. There are two basic ways to deal with administrative obstacles and managerial impediments to FDI; legislation to remove or moderate, and human resource management to change behaviour.

Image-building activities comprise consistently effective communication about the location. Image-building techniques must be accompanied by removing administrative obstacles and managerial impediments, investment-generation and investor-servicing activities, as on their own they are invariably wasteful.

Investment generation involves broad- or narrow-cast targeting as well as direct marketing to individual investors. The overall socio-economic development strategy of the country should not be overlooked in policy consideration during the investment generation process.

An investment promotion strategy should combine these techniques in innovative ways that suit the economic and industrial development requirements and the resources of an individual country. As such, prospects for sustainable efficient networking and effective linkages are possible. Without the combination of techniques in innovative ways prospects are dim. Attracting FDI for development is an increasing policy priority for both industrialised and developing countries. Winning in the ensuing competition for FDI hinges on how a country manages a number of factors that reflect the relative balance of its location specific advantages and disadvantages. Key among these is the networking role of the IPA as an intermediary, and provider of advantages that reinforce the distinct competitive advantages of the investor. Experience shows that a strategic approach can create the linkages sought and thereby capture more beneficial externalities.

NOTES

1. *Inter alia*, The Competitive Industrial Performance Index in UNIDO, 2002, Industrial Development Report 2002/2003, Vienna, UNIDO; Lipsey, R.E., 2001, Foreign Direct Investment and the Operations of Multinational Firms: Concepts, History, and Data, National Bureau of Economic Research, Working paper No. 8665, December; World Bank, 1993, The East Asia Miracle, Washington D.C., World Bank; Porter M.E., 1990, The Competitive Advantage of Nations, New York, The Free Press.

2. Antonelli, Cristiano, 1999, "The Evolution of the Industrial Organisation of the Production of Knowledge", Cambridge Journal of Economics, 23(2): 243-60.

3. Cohendet, P., F. Kern, B. Mehmanpazir and F. Munier. 1999, "Knowledge Co-ordination, Competence Creation and Integrated Networks in Globalised Firms", Cambridge Journal of Economics, 23(2): 225-41.

4. Industrial subsidiaries are increasingly linked and organised to perform mandates – value adding activities – in specific locations to preserve or enhance competitive advantage. Forward linkages are likely to be located close to markets where as backward linkages requiring high skill and technological intensities are likely to be located in high income, innovation-driven economic regions. Those activities that are standardised assembly intense with price elasticities of demand are likely to be located where appropriately skilled labour at low social employment costs is readily available.

5. Dunning, John H. 1997, *Alliance Capitalism and Global Business*, London, Routledge.

6. UNIDO, 2002, *UNIDO Industrial Development Report 2002/2003*, Vienna.

7. *Products with high export shares in world exports and with high growth rates in world exports*. See Lall, S., 2000, "The Technological Structure and Performance of Developing Country Manufactured Exports", 1985-1998. Oxford Development Studies, 28: 337-369; Mayer J., *et al*., 2002, Dynamic Products in World Exports, UNCTAD Discussion Papers, No. 159, May.

8. Foreign Direct Investor Perceptions in Sub-Saharan Africa: Further Statistical Analyses, Draft paper, UNIDO, Jan. 2003.

9. UNIDO can make available details of SPX successes that illustrate the range of achievements.

10. http://www.unido.org/afripanet

11. Foreign Direct Investor Perceptions in Sub-Saharan Africa, UNIDO Pilot Survey in Ethiopia, Nigeria, Uganda, United Republic of Tanzania, UNIDO, Vienna, 2002. (http://www.unido.org/userfiles/PuffK/02-55669.pdf) intended as an on-going forward look at investor intentions.

12. http://www.unido.org/itpo

13. It is intended to increase the country coverage of the surveys starting 2003 and to make the results available as a regular UNIDO publication.

14. Foreign Direct Investor Perceptions in Sub-Saharan Africa: Further Statistical Analyses, Draft paper, UNIDO, Jan. 2003.

Part IV

FDI PORTFOLIO CAPITAL FLOWS AND AID: CAPTURING THE SYNERGIES

SYNTHESIS REPORT

Ken Davies, OECD

Co-chaired by ***Mr. John Lintjer***, Vice-President of the Asian Development Bank (ADB) and ***Mr. Zoltán György***, Deputy Director-General of Investment, Trade and Development in Hungary LTD, and reported by ***Mr. Kenneth Davies***, Principal Administrator, Directorate for Financial, Fiscal and Enterprise Affairs of the OECD, this session focused on OECD experience of capital account liberalisation and the interaction between FDI and other inflows, including portfolio investment and ODA, as well as on strategies for investment attraction.

The scene was set by ***Mr. Jan Schuijer***, Head of Unit, Centre for Co-operation with Non-members, OECD Secretariat, who outlined the *OECD Members' Experience With Capital Account Liberalisation And Their Relevance To Other Countries*. He pointed out that the OECD's Code of Liberalisation of Capital Movements remains, after 40 years, the only non-regional instrument to make countries free up capital account operations and refrain from discrimination in this area. The Code is legally binding on OECD Member countries but can be considered as "soft law", as there are no sanctions to enforce compliance, which is ensured by consultations in OECD Committees, peer pressure from other members and recommendations by the OECD Council. Under the Code, members have had to roll back existing restrictions on cross-border capital flows – subject to reservations against obligations a country feels it can not meet immediately – and may not re-impose them (the "ratchet effect"). Members are also committed to non-discrimination among OECD members and so must apply (or lift) restrictions equally to all. They must notify the OECD of restrictions on (and liberalisation measures applying to) cross-border capital flows. The OECD membership examines restrictions and works to minimise them.

Mr. Schuijer then described the Declaration on International Investment and Multinational Enterprises, the OECD instrument that sets out the rights and obligations of foreign-owned enterprises, protecting them against discrimination and conflicting requirements, while offering them standards for good corporate conduct. Unlike the Code, the Declaration can be, and is, he said, adhered to by non-members.

The experience of the six countries that joined the OECD in the past eight years is, continued Mr. Schuijer, more relevant for any non-member wishing to emulate the Capital Movements Code than that of the founding members. The new members, he said, liberalised much faster than the founding members, as they did so in the 1990s, when the environment was more favourable. Nor did the new members introduce new restrictions, as had the founding members, even though they had encountered financial crises. Mr. Schuijer denied that the OECD had asked these countries to do too much too quickly, leaving them vulnerable to external shocks, because, he pointed out, the leading causes of the crises preceded the OECD accession process, the most volatile market segments had not been liberalised when the crisis hit, and these countries actually accelerated liberalisation as part of the cure for the crisis.

There has, said Mr. Schuijer, been a paradigm shift on capital account liberalisation in recent decades. The arguments in favour of it have become more compelling, i.e. that it: gives access to global savings, encouraging efficient allocation of productive resources; enhances competition among financial institutions; offers investors risk-reducing portfolio diversification; and improves worldwide corporate governance standards. Arguments in favour of restricting cross-border capital flows, founded theoretically on Mundell's "impossible triangle" (fixed exchange rate, independence of monetary policy and freedom of capital flows), were popular in an economic environment characterised by fixed exchange rates and credit controls, and are less relevant today.

The Capital Movements Code, pointed out Mr. Schuijer, has also developed to cover a wider range of cross-border capital flows, including most short-term operations. Originally, it was limited to transfers related to foreign direct investment, trade credits and certain longer-term securities. Maintaining controls on short-term flows was possible, he said, because capital markets in those days were more compartmentalised. In the 1990s, short-term flows were an important addition to the Code's liberalisation obligations.

New members, stated Mr. Schuijer, do not have to drop all their capital account restrictions before accession, but must refrain from restricting permitted international transactions, have an open foreign direct investment regime, have liberalised most long-term capital movements, and provide a timetable for liberalising restricted operations. Mr. Schuijer explained that the six new members had been able to liberalise more rapidly than the founding members because the advantages of capital liberalisation have become more widely accepted, countries need to maintain credibility, restrictions are now easier to circumvent, and countries no longer have an enforcement apparatus with which to re-impose controls.

In addressing the question of the sequencing of financial liberalisation, Mr. Schuijer said that commitment to liberalisation should not be allowed to wait until a country's domestic financial system has become sophisticated enough to withstand financial shocks. Capital account liberalisation and domestic financial reform are, he said, mutually reinforcing. Korea realised this and actually speeded up its liberalisation after the onset of the financial crisis in 1997. The causes of the crisis were, as acknowledged by the Korean government, nothing to do with Korea's accession to the OECD.

Ms. Kimberley Evans, International Economist, United States Department of Treasury, considered the question *Do FDI and portfolio investment complement one another?* She pointed out that the OECD had recognised the importance of capital account liberalisation forty years ago and that its approach has since evolved. Adequate capital flows, suggested Ms. Evans, were needed for economic growth, since they added foreign investment to domestic savings as sources of investment. Ms. Evans said there was a tendency to denigrate portfolio investment and praise foreign direct investment (FDI). It was, she said, helpful to distinguish – but not discriminate in policy terms – between them on the basis of whether or not the investor had control over the investment.

The benefits of FDI were, she said, that it: provided competition to spur productivity in the domestic sector; provided training in technical and managerial skills, boosting the development of human capital; increased trade opportunities; and raised living standards. Portfolio investment, Ms. Evans added, also had benefits, in that it: increased capital market liquidity; provided more opportunities for savers and more opportunities to raise capital for new enterprises; raised transparency standards in such areas as accountancy; improved corporate governance; and introduced more sophisticated instruments to help manage portfolio risk. Ms. Evans stated that open capital markets gave investors greater opportunities to diversify and enhanced the benefits provided by FDI. Both portfolio investment and FDI, she said, enhance transparency and corporate governance. However, the benefits of both types of investment take time to become apparent and are not inevitable, since, she maintained, they depend on an adequate policy and regulatory structure.

Ms. Evans pointed out that FDI involves control of an enterprise, is difficult to divest and is less volatile, while portfolio investment provides maximum return for lowest risk, and is more volatile. This volatility may involve system-wide movements. Good regulation is, she pointed out, needed to deal with volatility by managing risk and ensuring adequate prudential supervision. Regulators are most effective when they create incentives for good behaviour. Government interference (and ownership) can prevent market signals from working.

Ms. Evans said that policies that create an enabling environment for FDI are also good for domestic enterprises. Features of such an environment include good physical and financial infrastructure as well as good health and education. Such an environment is, she continued, best sustained when there is an adequate political and social infrastructure, with rule of law, transparent government, good corporate governance, property rights (including intellectual property rights), protection against confiscation and the freedom to move capital in and out.

Ms. Evans denied that FDI and portfolio investment were entirely separate, pointing out that there was no identifiable dividing line and there were areas of overlap, such as venture capital lending for a start-up enterprise. Direct investors, she said, become portfolio investors as they manage their capital. Therefore what is done to one will affect the other: trying to keep either FDI or portfolio investment out will hurt both. Both types of foreign investment should, concluded Ms. Evans, be welcomed and regulated in order to maximise benefits and minimise costs.

Commencing the panel discussion, an NGO perspective was provided by ***Mr. Rajan R. Gandhi*** of the Consumer Unity and Trust Society, India, who posed the question *What actions are needed to attract and maximise benefits of FDI for developing countries?* In a survey of seven countries including Brazil, South Africa, Tanzania, Hungary, Bangladesh and India, his Society had found that there was a total lack of homogeneity in FDI, which was divided between such categories as market-seeking and resource-seeking, and that a wide range of inducements was used to attract FDI. It was felt by the authors of the survey that FDI was desirable but that it was currently inadequate. The study also found, Mr. Gandhi reported, that much FDI goes against what he called the "conventional wisdom", for example the assumption that FDI was attracted by infrastructure (but much FDI goes into infrastructure) or the requirement for a pre-existing strong regulatory framework (but China and India both receive FDI)

Among common features evident in the countries studied, Mr. Gandhi outlined five disincentives to FDI: war or the threat of war; civil strife, law and order problems; absence of an exit policy; absence of a stable economic policy and a stable exchange rate; unfavourable preconceptions and stereotypes.

Mr. Gandhi then enumerated four ways of maximising the benefits of FDI listed by India ten years earlier and pointed out their drawbacks. Technology transfer has, he said, been incomplete because the technology did not always include complex components such as gearboxes. The transfer of marketing expertise was also not totally effective because multinational corporations have been given the run of the market. The transfer of modern management techniques had been helpful insofar as it meant the adoption of quality control methods, he continued, but sometimes it involved slavish adherence to standards set overseas.

Mr. Gandhi criticised the view that resource-seeking FDI is exploitative, since without FDI a country would be unable to use the resources concerned. He also disagreed with criticisms of cross-border acquisitions as constituting a lower quality of FDI, pointing out that when a foreign investor buys a local company to enter a market, resources are then freed for local investors.

Mr. Eduardo Pires Ferreira, the Business Development Director of Investe Brasil, spoke on *Brazilian FDI/portfolio investments: a strategy for investment attraction*. He started by pointing out that Brazil has already achieved privatisation. Investe Brasil was formed in 2002 to facilitate the investment process for all businesspeople. Since its structure included both government and the private sector, it was extremely representative of society as a whole and therefore spoke with authority. The focus of Investe Brasil's work is on FDI sectors often considered "not so natural", such as infrastructure and trade. A major aim is to provide jobs, as there is a need to employ an extra 1.4 million each year to accommodate population growth.

Investe Brasil aims, said Mr. Fereira, to provide a "one-stop shop" service. It had not yet achieved this, he continued, but was heavily involved in "matchmaking", publicising investment opportunities and encouraging investors to reinvest their earnings in Brazil.

Mr. Fereira listed various entry points for foreign investors, including the Ministry of Foreign Trade (MRE), Brazilian missions abroad, trade fairs, and a web site that is already working, though still under development. He said that the web site was particularly important for small and medium-sized enterprises, since big companies "come on their own legs".

Mr. Fereira said that an Investor Support Network consisting of people in key government posts had been set up to solve problems for and support foreign investors.

The result had been, he concluded, the inauguration of 61 projects, three of which have already been completed, in eight months. These projects, he said, covered the whole spectrum of the Brazilian economy.

Mr. Mehmet Ögütçü, Head of the Non-Members Liaison Group and of the Global Forum on International Investment in the OECD's Directorate for Financial, Fiscal and Enterprise Affairs, concluded the panel discussion with a presentation on *FDI and ODA: Creating Synergies*. He pointed out that the ten key strategies of development listed in the 1969 Pearson Report recommendations remained valid. The goal of allocating 0.7 per cent of GDP to overseas development assistance (ODA) was still a distant goal: only 5 OECD member countries now meet it, although OECD member countries provide 95 per cent of all official aid – US$53.7 billion in 2000 (down from US$60.8 billion in 1992) – and 80 per cent of global FDI.

Mr. Ögütçü pointed out that while there were good examples of aid being used effectively to reduce poverty and sustainable development, there were also many complaints and criticisms of ineffective aid. Now that trade and investment are producing increased benefits, he said, ODA is now expected to concentrate on building institutions of good governance and investing in human capital. Most bilateral aid, stated Mr. Ögütçü, is still tied, and the OECD is now discussing untying it. The OECD's Development Assistance Committee proposed in April 2002 that aid to most developing countries be untied and that it be concentrated in such areas as balance of payments assistance, debt forgiveness, and export and commodity production support. The quality of ODA, insisted Mr. Ögütçü, is as important as its quantity. Another major problem is that ODA is badly distributed.

Mr. Ögütçü reiterated that there were effective synergies between ODA and FDI that needed to be exploited. Carefully-targeted ODA was, he said, necessary to help countries whose FDI absorption capacity was weakest. Mr. Ögütçü said that FDI was not a means of filling the gap left by insufficient ODA, but should be seen as complementary to ODA. There is, he said, a need to improve synergies between FDI and ODA. In addition, both donors and recipients need to understand each other and involve civil society organisations.

OECD MEMBERS' EXPERIENCE WITH CAPITAL ACCOUNT LIBERALISATION AND ITS RELEVANCE TO OTHER COUNTRIES

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The OECD Code on Liberalisation of Capital Movements

The OECD is over forty years old and so is its main instrument to achieve capital account liberalisation: the Code of Liberalisation of Capital Movements. Strikingly, the Code is still the only single multilateral legal instrument that requires its adherents to open up their capital markets and refrain from discriminating against foreign investors, although regional instruments also exist, such as the relevant Directive promulgated by the European Commission in 1988.

The OECD's Capital Code is a legally binding instrument. Nevertheless, it is "soft law" in the sense that it is not enforced by law courts and that there are no sanctions for non-compliance. If an OECD member is found to contravene its obligations, there will be consultations in the relevant OECD Committees, peer pressure from the other members, and eventually a recommendation by the OECD Council. This system does work, but the process is sometimes drawn-out and arduous. For all practical purposes, the political commitment that member countries undertake to meet the standards of the Code is more important than its legally binding nature.

The main provisions of the Code are the following:

- Rollback: A general undertaking to liberalise cross-border capital flows progressively.
- Reservations: The right to lodge reservations against those obligations that the country feels it cannot meet immediately.
- Ratchet: For most types of operations, it is impossible to re-impose restrictions that have been lifted, except under temporary derogations in case of serious problems for the balance of payments or the financial system.
- Non-discrimination: An obligation not to discriminate among OECD members: any restrictions should be applied equally to all, and once an operation has been liberalised, this too, should benefit all other OECD members.

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* This paper is largely based on the work carried out by Eva Thiel, Senior Economist, DAF/CMIS, on *40 Year's Experience with the OECD Code of Liberalisation of Capital Movements*, OECD 2002.

- Notification: An obligation to notify the OECD of any restrictions on cross-border capital flows.

- Examination: Restrictions will be examined by the OECD membership and members will advise and exert peer pressure with the aim of limiting any restrictions to a minimum.

The Capital Movements Code should not be confused with another OECD instrument, namely its Declaration on International Investment and Multinational Enterprises. The Code deals with liberalisation of all capital flows. The Declaration deals primarily with the rights and obligations of foreign-owned enterprises: it protects them against discrimination and conflicting requirements and offers them a set of standards for good corporate conduct, the OECD Guidelines for Multinational Enterprises. Furthermore, the Code is adhered to by OECD members only, whereas the Declaration can be acceded to by non-members, and actually is.

Capital account liberalisation: A new paradigm

Having committed itself to progressive capital account liberalisation for more than forty years, the OECD Members do have a story to tell on the subject. But I must issue a caveat: not all of our member countries have been with us for the full forty years. Indeed, six of them joined the OECD only during the past eight years: Mexico, the Czech Republic, Hungary, Poland, Korea and Slovakia. The experience of these six new members is not only more recent, it is also more *relevant* for any non-member that may wish to emulate the standards of the Capital Movements Code. I should stress this point even more strongly: it would be misleading to suggest that anything our founding members have done over the past forty years provides a script for any other country that wishes to open up its capital market to the outside world.

This was not immediately obvious to some of our new members. For example, the Koreans set out by arguing that, if many OECD members had taken 20 to 30 years to complete their liberalisation process, they should not be expected to take less. It took a while to convince the Koreans that the times had changed. However, Korea is now convinced, and it is none the worse for it. Indeed, it is no coincidence that the six new members have liberalised much more swiftly than many of the old: their liberalisation was pursued in the 1990s, in an environment that was radically different from that of the 1960s and 1970s, as I will explain in a moment. Even more importantly, unlike some of our founding members, the newcomers have not turned the clock back by introducing new restrictions along the way, barring some minor exceptions. This was all the more striking as some of them were hit by serious financial crises, not least Korea, but also Mexico, and to some extent the Czech Republic.

Financial crises, indeed, hit these countries just after they had joined the OECD and undertaken to open up their capital markets. It begs the question whether the OECD had asked these countries to do too much too quickly, thus leaving them unduly vulnerable to external shocks. Legitimate as the question is, the answer must be "no". I will deal with it in greater detail in a few minutes, but first make three points: *(i)* the l seeds of the crises were already in place before the countries' accession to the OECD started, *(ii)* the most volatile segments of the financial and capital markets had not been liberalised when the crisis hit, *(iii)* last but not least, the countries in question tended to accelerate their liberalisation process in response to the crisis: to them, liberalisation was part of the cure, rather than a luxury which they would not be able to afford until after their recovery.

This last point underlines how much of a paradigm shift we have seen on capital account liberalisation over the past few decades. The arguments in favour of liberalisation have become more compelling, the arguments against it less so. To summarise the main benefits of liberalisation:

- It offers access to a global pool of savings, which fosters their allocation towards the most productive uses.

- It enhances competition among financial institutions, improving their efficiency.

- It offers investors ways to diversify their portfolios and thereby to reduce risks.

- It familiarises issuers of securities to advanced disclosure and corporate governance standards in foreign markets, which helps to improve such standards world-wide.

Arguments in favour of *restricting* cross-border capital flows had their heyday in the 1960s, when the Capital Movements Code was first established. In those days, restrictions on cross-border capital movements were widespread and seen as a legitimate way of preserving monetary policy independence and the exchange rate. The charter of the IMF expressly allowed for such restrictions, as a complement to the Bretton Woods system of fixed exchange rates. It still does, and only recently has it been a point of serious discussion whether this clause in the IMF's articles of agreement should be amended, but any momentum seems to have been lost in the financial crises of the late 1990s.

Most arguments that countries put forward for capital restrictions were variations on a common theme, also known as Mundell's "impossible triangle": that it is impossible to maintain a fixed exchange rate, independence of monetary policy and freedom of capital flows at the same time. Official arguments for restricting capital outflows were expressed as a need to safeguard monetary reserves, to help maintain external equilibrium, and to protect the currency. Arguments for restricting capital inflows were related to monetary policy autonomy, and also to a policy of preventing foreign control in certain key economic sectors.

The economic environment in those days was not only one of fixed exchange rates. Monetary policy was often conducted differently from today, with a stronger emphasis of direct methods of credit control. For example, my native country, the Netherlands, retained the option until the late 1980s to impose controls on foreign credits, whenever the central bank set a ceiling on domestic credit expansion. Logically, a domestic credit ceiling could be circumvented by borrowing abroad. Given the fixed exchange rates, such credits from abroad would have expanded the money supply, thus undermining the central bank's restrictive monetary policy. Capital controls were therefore seen as a necessary complement to direct credit controls.

Another difference with today's environment was that capital markets used to be more compartmentalised than they are nowadays, with strict separation between short-term and longer-term markets. This made it easier than it is today to liberalise the longer segments of the markets, while keeping the shorter under tight control.

In keeping with the times, the Capital Movements Code of the 1960s and 1970s was therefore limited in purpose: the items it covered included the transfers related to foreign direct investment, trade credits and certain longer-term securities. But it seemed only natural that "hot money flows", short-term capital movements of a predominantly speculative nature, should not be covered. Indeed, the Code would not contain any requirements to liberalise such flows until the 1990s. This extension of the Code to cover short-term capital and a range of other items vastly extended its scope, but also its importance. This was particularly clear in the mid-1990s, when the accession procedures for six new OECD members started: the Capital Movements Code had taken centre stage as a touchstone for the assessment of candidate countries' willingness and ability to assume the obligations of OECD membership.

A touchstone for OECD membership candidates

New members are not required to drop all their capital account restrictions overnight before acceding to the OECD. Rather, they will be asked:

- To refrain from restricting payments and capital transfers in connection with permitted international transactions.

- To have an open and transparent regime for foreign direct investment.

- To have liberalised all or most long-term capital movements, in particular those involving shares and longer-term bonds.

- To provide a timetable for the future liberalisation of any restricted operations.

As a general rule, the six new OECD members have stuck to their agreed undertakings and timetables. The main problem occurred with Poland, which had originally committed itself to abolishing all its restrictions on portfolio capital by the end of 1999, but in the end adopted a foreign exchange law that maintained certain safeguard measures to restrict all non-FDI capital flows in cases of unspecified “extraordinary risk” to Poland’s financial system. OECD members found this to be not quite in line with Poland’s earlier undertakings. Nevertheless, it is important to note that all new members have stuck to their commitments to liberalise their capital accounts according to plans, without invoking any derogation clause, and this in spite of circumstances that were much graver than foreseen at the time of their accession. Why is it that capital restrictions are no longer seen as a serious policy option among OECD member countries and that even the new members have accomplished their liberalisation in a much shorter time span than many of the founding members? Important reasons are:

- The cure may be worse than the disease: reneging on earlier commitments undermines governments’ credibility, which is the last a country needs in times of crisis and the effects of which may be felt even long after the crisis has passed.

- The advantages of capital liberalisation have become more manifest and widely accepted than they were until 15-20 years ago.

- Restrictions can be more easily circumvented, as capital markets have become more sophisticated, with the emergence of advanced instruments blurring the distinctions between their short-term and long-term ends, so it makes more sense to “go all the way” swiftly, rather than to opt for a drawn-out sequencing of liberalisation.

- Monetary policies have changed and now rely less on direct controls than indirect, market-based ones, and therefore less on the option of (re)introducing capital controls.

- Maintaining capital controls requires an enforcement apparatus, i.e. an infrastructure of controlling officials and authorised foreign exchange banks, which in most OECD countries has been dismantled and cannot be easily resurrected.

While all these arguments militate in favour of sticking to liberalisation commitments, even if times are bad, there is a legitimate question as to whether such commitments should not be allowed to wait until a country’s domestic financial system has become sophisticated enough to withstand external shocks: the sequencing question. This is precisely the concern raised by Korea during its negotiations on OECD membership in 1995 and 1996, in the knowledge that its banking system was already weak at the time.

One answer is that, yes, a less advanced domestic financial system will be more vulnerable to external shocks than a more sophisticated. However, this is only part of the story, the reason being that domestic financial reform and capital account liberalisation are not two separate processes: they mutually reinforce each other. This is so because both capital account liberalisation and domestic financial reform will enhance the role of foreign banks on the domestic market. This will reinforce competition in the banking sector, introduce advanced financing techniques involving foreign capital and, finally, introduce advanced standards for supervision, disclosure and corporate governance. It is worth noting that Korea, after the outbreak of the financial crisis in 1997, decided to liberalise the participation of foreign banks on its domestic market in full, and to take a number of other liberalising measures, for example on inward financial loans. These were moves which Korea had still resisted ahead of the crisis.

Conclusion

This brings me to my final point: did Korea's liberalisation, agreed in the context of its OECD accession, aggravate its 1997 financial crisis? It must be remembered that a leading cause of the crisis was the existence of currency and maturity mismatches which resulted from cross-border borrowing by Korean banks on the interbank market. These operations were already liberalised long before Korea's accession to the OECD and played no role in the accession negotiations. Furthermore, the OECD did not require Korea to liberalise foreign investment in short-term capital market instruments and financial credits, which remained fully restricted at the time of Korea's accession. Finally, the OECD did point out the prevailing weaknesses in Korea's financial system, and not least the need for modernising its supervisory framework. To quote the former Permanent Representative to the OECD, Dr Soogil Young: "Korea's financial crisis happened because of problems at home and had nothing to do with its accession to the OECD." With this, I rest my case.

FOREIGN PORTFOLIO AND DIRECT INVESTMENT: COMPLEMENTARITY, DIFFERENCES AND INTEGRATION

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In light of the various capital crises in the past few years, there has been a tendency to denigrate portfolio investment, while singing the praises of direct investment. Yet, it is also recognized that efficient capital markets help to mobilize financing for growth and development. Both direct and portfolio investment can promote sustainable growth in developing, and industrialized, economies, albeit in different ways.

Both portfolio and direct investment provide economic benefits, and the two together can enhance those benefits. It is not helpful to discriminate against one type of investment or the other, although it is necessary to recognize their differences. With the right policies, both can contribute to a strong and healthy economy.

This paper will explore both the relationships between portfolio and direct investment, and their differences under the assumption that the difference between the two is whether the investor has control over the investment, or not. It will first analyse the benefits of each type of investment: how those benefits differ and how they are complementary. It will also highlight the different policy needs of and approaches to the two types of investment, and where those are shared or complementary. Lastly, it will look at how the two types of investment are integrated in their operations, and at the margin between them. In this way, the paper is intended to show why the best policy is to welcome both forms of foreign investment, with full recognition of their differences.

Benefits – complementarity and differences

Adequate capital flows are a basic and now universally acknowledged requirement for economic growth. The provision of capital is probably the most fundamental point of similarity between portfolio and direct investment. Both forms of foreign investment provide capital flows beyond those available through domestic savings. Both serve to boost investment and economic activity in the domestic economy, allowing a higher level of economic growth than would otherwise be possible.

Both foreign direct and portfolio investment bring a range of benefits for economic growth, though there may be a marked difference between those benefits.

Benefits of foreign portfolio investment

Foreign portfolio investment increases the liquidity of domestic capital markets, and can help develop market efficiency as well. As markets become more liquid, as they become deeper and broader, a wider range of investments can be financed. New enterprises, for example, have a greater chance of receiving start-up financing. Savers have increased opportunities to invest with the assurance that they will be able to manage their portfolio, or sell their financial securities quickly if they need access to their savings. In this way, liquid markets can also make longer-term investment more attractive.

Foreign portfolio investment can also bring discipline and know-how into the domestic capital markets. In a deeper, broader market, investors will have greater incentives to expend resources in researching new or emerging investment opportunities. As enterprises compete for financing, they will face demands for better information, both in terms of quantity and quality. This demand for fuller disclosure will promote transparency, which can have positive spill-over into other economic sectors. Foreign portfolio investors, without the advantage of an insider's knowledge of the investment opportunities, are especially likely to demand a higher level of information disclosure and accounting standards, and bring with them experience in utilizing these standards and a knowledge of how they function.

Foreign portfolio investment can also help to promote development of equity markets and the shareholders' voice in corporate governance. As companies compete for finance the market will reward better performance, better prospects for future performance, and better corporate governance. As the market's liquidity and functionality improves, equity prices will increasingly reflect the underlying values of the firms, enhancing the more efficient allocation of capital flows. Well-functioning equity markets will also facilitate takeovers, a point where portfolio and direct investment overlap. Takeovers can turn a poorly functioning firm into an efficient and more profitable firm, strengthening the firm, the financial return to its investors, and the domestic economy.

Foreign portfolio investors may also help domestic capital markets by introducing more sophisticated instruments and technology for managing portfolios. For instance, they may bring with them a facility in using futures, options, swaps and other hedging instruments to manage portfolio risk. Increased demand for these instruments would be conducive to developing this function in domestic markets, improving risk management opportunities for both foreign and domestic investors.

In the various ways outlined above, foreign portfolio investment can help to strengthen domestic capital markets and improve their functioning. This will lead to a better allocation of capital and resources in the domestic economy, and thus a healthier economy. Open capital markets also contribute to worldwide economic development by improving the worldwide allocation of savings and resources. Open markets give foreign investors the opportunity to diversify their portfolios, improving risk management and possibly fostering a higher level of savings and investment.

Benefits of foreign direct investment

With its orientation to developing enterprises directly, foreign direct investment helps to strengthen economic potential. Sometimes, this is accomplished through greenfield investments, adding new and different economic activity and consequently diversifying the economy. Other times, this will be achieved through building up existing enterprises and enhancing their potential. Both of these activities will add a new and healthy element of increased competition to an economy, which is in itself a powerful force for economic development.

Competition is one of the ways through with foreign direct investment can have a broader effect on the economy. It spurs other enterprises to increase their own efficiency and productivity. Competition plays a major role in improving the allocation of resources, boosting the economic prospects of the domestic economy and worldwide sustainable economic development. Technology transfers and the development of human capital are often seen as two of the primary benefits of foreign direct investment. Competition has a role to play in both, as it encourages domestic competitors of the foreign investment to build up their own technological capabilities and the productivity of their labour force. They will, among other things, learn from the technology of the foreign investor and the ways in which it improves the productivity of its labour and management.

The development of human capital can be one of the chief contributions of foreign direct investment. Foreign owners will bring management skills and technology to their enterprises. In training the local workforce, they will pass on those management skills and technology. As their workers move on to other jobs in domestic firms, or start their own businesses, they will bring with them the management, working skills, and the technology that they have learned. Thus, in a very direct manner, the human capital of the host country can be developed by foreign direct investment, and the investment' technology transferred.

Human capital development and technology transfer also occur through the foreign investment's relationships with its suppliers and the downstream users or sellers of its products. The investment will require from its suppliers a certain standard of product, perhaps a higher standard than they are accustomed to producing. In order to meet that higher standard, they will have to improve their workers' skill levels and their management system. They may also gain new technological expertise needed for the required product standard from the foreign investment. The current trend toward outsourcing and closer collaboration along the supply chain means that there will be a greater tendency to pass management, production and technology know-how to suppliers, enhancing the transfer of technology and skills. Enterprises that are downstream in the supply and sales chain will receive similar benefits, although less obviously and perhaps less frequently, both through the direct use of a higher standard product incorporating technological improvements, and through efforts by the foreign investment to maximize the value of its product.

Foreign enterprises often incorporate foreign trade, either with the parent company or with customers, or both. Thus, another benefit that foreign direct investment brings is increased opportunities and avenues for trade. Trade and investment are increasingly integrated, as are their benefits.

Foreign direct investment can also provide environmental and social benefits. Often, international investors will operate at higher environmental and social standards than their domestic competitors. Although they may not bring standards up to the highest level possible, they will have the effect of raising the standards above existing levels. These standards may also be adopted over time by domestic companies, further raising the country's environmental and social standards.

Shared attributes and complementarity of the benefits

Many of the benefits mentioned above for either type of investment will not be immediately apparent. A foreign direct investor's relations with the domestic economy, with suppliers, users, and sellers of its products, will develop over time. Likewise, the portfolio investor's relationship to the domestic capital markets and impact on the markets' efficiency will evolve over time. Few, if any, of these benefits are guaranteed. For both direct and portfolio investment, having an adequate policy and regulatory structure is necessary to reap the potential benefits. Both types of investment, each in their own way, also reward transparency and good corporate and public governance – thus providing an incentive to improve in those areas.

A healthy domestic economy also enhances the benefits that foreign direct investment can provide, and a sound financial sector is a prerequisite for economic health. As shown below, the benefits of foreign portfolio investment require a suitable prudential regulatory system, but prudential regulation is also necessary for a sound domestic financial sector and overall economic health. The contribution of foreign portfolio investment to strengthening domestic capital markets and their infrastructure, which enhances the domestic allocation of capital, can help to boost the benefits of foreign direct investment. Therefore, the two are also complementary in that their benefits are enhanced when both are present.

Policy differences and complements

Complementarity, however, does not mean that the two types of investments are the same, or that they should receive the same policy responses. We have seen in the previous section that although the benefits of foreign portfolio and direct investment are often shared or complementary, there are also marked differences between them.

Differences between portfolio and direct investors stem from the differences in motivation and expectation for these two types of investment. For the foreign direct investor, the purpose is control and operation of an enterprise. Just as it will be slower and more costly for such an investor to commit to the host economy, it will be slower and more costly to divest. In the medium to long term, he expects a profitable operation. The portfolio investor, on the other hand, is interested in putting funds where they yield the maximum return for a given level of risk. Portfolio investment will be faster to move in search of higher returns and/or lower risk, and have a shorter time horizon. Therefore, it will tend to be more volatile. Volatility can be useful in providing opportunities for profit, or arbitrage, which will attract investors and encourage market efficiency. Volatility also indicates that the market is seeking the best allocation of capital for the current economic opportunities. But, portfolio investment, with its volatility, can also experience system-wide movements of capital which can have broad economic repercussions. These differences in motivation and attributes necessitate differences in policy approach for the two types of investment.

Policies for foreign portfolio investment

For foreign portfolio investment, strong and well-regulated financial markets are necessary to deal with the inherent volatility. The financial system must have the capacity to assess and manage risks if it is to prudently and productively invest capital flows, foreign or domestic. Its central role of financial intermediation and credit allocation is a key element of economic growth and development. As has been shown above, foreign portfolio investment can be an important player in this function, and bring additional strengths and benefits, but those benefits will be most effective when working within a healthy financial system.

For a financial system to maintain its health, the institutions within it must be able to identify, monitor and manage business risks efficiently. The payments system, through financial institutions and clearing houses, must be efficient and reliable. The financial system must also have the ability to withstand economic shocks, such as a substantial shift in the exchange or interest rates, or a sudden capital withdrawal. It must, as well, be able to withstand systemic shocks, such as financial distress or bank failure. Systemic risk, from economic or systemic shocks, is a central, and perhaps unique, element of capital markets. It demands adequate capitalization and risk management capabilities.

Adequate and sound prudential supervision is necessary for a healthy financial system. Financial institutions face a myriad of risks: from credit risk to exchange rate risk, from liquidity risk to exposure concentration risk, from various risks stemming from the institution’s internal operations to risks inherent in the payments system. Supervisors need to have a sound understanding of all these types of risk and how they can be managed. They also need to understand the environment in which the banks operate, and the various ways these risks can be transmitted. Adequate capital is a necessary element of prudential regulation, providing a safeguard against losses and a cushion in the face of institutional or systemic problems. Financial institutions should also limit their exposure to individual or associated counterparties, to related parties, to market risk, to short-term debt or mismatches in liquidity. The IMF and World Bank have developed effective banking supervision frameworks through financial sector surveillance and assessment, carried out, at least in part, through the Financial Sector Assessment Programme and through Reports on Observance of Standards and Codes.

Although supervisors need to be able to verify that a financial institution's exposure is balanced and capital is adequate, the extent of specificity in the regulations should be a function of the overall soundness and structure of the financial system. Regulation and regulators will be most effective when they create incentives for sound behaviour and when their application and practices are able to evolve with the needs of the market. Supervisors need to be aware of the risks and costs of excessive prudential regulation. The costs will be seen in the time and resources required to comply with the regulations, which should be balanced against the need for regulation, but they will also be seen in the effect on innovation and evolution in the markets, which can bring benefits to both the financial markets and the broader domestic economy. Excessive regulation and supervision can put the onus for effective management of financial institutions on the supervisory authorities, rather than the directors and managers of the institutions. This will reduce the effectiveness of management and of market disciplines, potentially the most practical and efficient "regulators." The right balance is essential.

Market discipline can provide the greatest incentives for effective risk management. Therefore, it is important not to thwart it by excessive regulation, but there are other factors to watch to ensure that market discipline is effective. Market discipline depends on clear signals from the market. Government guarantees of financial institutions, or implicit government support, can keep the market from signalling a growing problem, as can government ownership. Financial safety nets and market failure response arrangements need to be able to effectively resolve market distress situations, without creating unnecessary moral hazard. If financial safety nets and market failure responses are not appropriately designed, they can take away, or at least reduce, the financial institution's incentive to manage its risks adequately, the first and best line of defence against risks. Competition in the financial sector will also strengthen market disciplines, and a financial sector open to foreign investment, which can bring with it new and different outlooks and approaches to these problems, will help attain the benefits of competition.

A sound financial system is best sustained when the broader legal, political and economic environment is also marked by sound policies. As these boost the benefits of both portfolio and direct investment, we will return to them below.

Policies for foreign direct investment

To maximize the economic benefits of foreign direct investment, the key element is the state of economic development and sophistication of the domestic economy. The closer the match to the foreign enterprise's needs and sophistication, the more ties to the domestic economy are likely to develop over time. This will facilitate the transfer of technology and know-how.

In general, then, sound policies for foreign direct investment mirror sound policies for domestic economic development. Policies that will maximize the benefits of foreign direct investment, and minimize its costs, or potential drawbacks, are those that will do the same for domestic investment. One of the basic aims of investment policy should be to create an enabling business environment, facilitating the growth and development of all businesses, small and large, domestic and foreign.

Just as with portfolio investment, sound regulation is important for foreign direct investment. However, regulatory details for the myriad business sectors and activities in which a foreign direct investor are involved would be impossible to summarize. In all cases, however, maintaining health and the environment are legitimate and necessary subjects of regulation. As a basic approach to regulation, creating an incentive structure to encourage compliance with the spirit and letter of the laws and regulations is more productive than surrounding the business operations with rules that may, or may not, be the best way to reach the regulatory goals envisioned. For instance, markets in pollution credits have proved an effective way to stimulate firms to find the most efficient ways to reduce pollution.

To get the greatest benefit from foreign direct investment's potential to transfer technology and strengthen the skills of both labour and management, domestic human capital needs to be developed to the point where it is able to absorb and integrate the knowledge that the foreign investor has to offer. Therefore, a policy of developing domestic skills and knowledge is necessary to reap the full benefits of foreign direct investment. The two most fundamental elements to that policy are health and education. Basic human health and primary education are prerequisites to developing the skills and knowledge needed to get the full benefits of foreign direct investment, and for domestic economic development, as well.

Health and education prerequisites require infrastructure. Not only must there be an infrastructure to deliver health and education services, either public or private, but there must also be infrastructure to deliver clean water and to manage waste. To integrate the foreign enterprise into the domestic economy, and thus maximize the benefits it has to offer, adequate commercial infrastructure is necessary, which would include energy, communications, transport, and financial infrastructure.

These are the elements needed to derive the greatest benefit from foreign direct investment. Other than the need for regulation acknowledged in both cases, these elements are different from the policies outlined above to minimize the risks from portfolio investment. Yet, there are underlying policy needs, such as the need for good governance, which apply to both types of investment.

Policies for both foreign direct and portfolio investment

A stable macroeconomic environment is conducive to sustainable, non-inflationary growth. Volatility in interest rates or exchange rates and high inflation have had obvious deleterious effects in financial markets, but their negative effects are not limited to portfolio investment. Direct investors also find it harder to operate successfully in such an environment. Policies that minimize, or eliminate, distortions to price signals – be they signals for interest, wages, or goods and services prices – promote improved resource allocation in both the capital markets and the economy as a whole.

The rule of law is paramount for healthy economic growth. Portfolio and direct investors need a reliable legal system ensuring that agreements and arrangements in either the public or the private sector will be honoured. Yet, neither should need to rely purely on pursuing their rights through the legal system. Good and honest governance will help keep resources focused on their most productive use, rather than pursuing legal rights or paying bribes. Reliable corporate governance provides for stronger relationships throughout the economy and helps to promote financial stability. Financial disclosure is particularly important for portfolio investment, and for a strong and stable financial system.

For both direct and portfolio investment, the policies promoted through international investment agreements and treaties are beneficial. Transparency, first and foremost, guarantees that investors will know what is expected of them, and the rules of the game. For portfolio investors, if transparency is in place for both the government and their counterparties, they will be better able to anticipate and deal with market disruptions. Thus, transparency can make the capital markets more stable. For direct investors, transparency allows them to plan ahead for the most productive use of their resources. If transparency includes plans to change policies or rules and regulations, which it should, then transparency can also give direct investments a chance to anticipate and prepare for a change in the political regime.

Preventing discrimination on the basis of nationality is a central aim of our investment agreements. Direct investors will clearly hesitate to invest if they have reason to believe that the host government will hamper their ability to compete on an equal footing with competitors in the markets. For portfolio investors, discrimination will harm their potential return or raise their potential risk level. They will have no compunction about looking elsewhere for a better deal. For the domestic economy, discrimination on the basis of nationality, or most any other form of discrimination, will deprive the economy of the full contribution that could have been provided by the investment.

Both types of investment and investors must be able to count on property rights. For direct investors this is a broader issue, as there are more types of rights involved, including intellectual property rights. Protection against expropriation is vital, and if expropriation is necessary, it must be carried out with due process and prompt, adequate and effective compensation. The portfolio investor may have a smaller range of issues to be concerned with under property rights, but that does not make them less important to the investor. Although the government cannot, and should not, guarantee a stable value for the portfolio investment, or guarantee against default, the investor should be assured of his rights *vis-à-vis* the financial markets and the financial instruments he holds.

Clearly, the right to move their capital freely in and out of the country will be crucial to both types of investors, and perhaps more so, in this case, to the portfolio investor. In either case, however, they will be loath to invest if they do not have assurances that they will be able to remove the capital as needed or desired.

Integration

Thus far, we have treated portfolio and direct investment as if they were separable entities. That is a bit misleading. Although, as we have seen, portfolio and direct investment have different needs and will react to situations in different ways, driven by the differing motivations of the investors, they cannot be completely separated.

There is no identifiable dividing line between portfolio and direct investment, but only an area of overlap where the two merge. For instance, a portfolio investor may be active in the equities market, but equity holdings are also one of the main means of direct investment. At what point does the portfolio investor become a direct investor? The same overlap can also be found with debt holdings. Corporate bonds are a typical portfolio investment, and in most cases would not be considered a direct investment. But, what about the case where a venture capitalist loans a start-up company a large amount of money, underwriting a large share of the start-up's assets? The venture capitalist may not hold any evidence of ownership because no shares have been issued, only debt. Nor may he have measurable control over the start-up, but he is actively helping management to run the business efficiently, to boost the likelihood of making good on his investment. Is he a portfolio investor, or a direct investor? At what point does he cross the line between the two?

Another way in which foreign direct investment and portfolio flows are integrated is the concomitant use of the two types of investment. Direct investors will be engaged in portfolio investment as they manage their cash flows. For example, the treasurer of a large retail chain will be in and out of the capital and money markets as he manages the cash and other financial assets involved in the business. Any classic direct investment of any size and autonomy will have a similar treasurer's function, and be an active portfolio investor.

Therefore, there is no firm dividing line between portfolio and direct investment, but instead overlap and integration. At what point does portfolio investment become direct?

For legal and policy purposes, it is at the point where the investor exerts some measure of control over the underlying economic entity. This does not have to be full control, or even majority control. There can be more than one investor exerting control over an investment – a partnership or joint venture are familiar examples. The point where the investor gains some real measure of influence over the operation of the investment is the point where he crosses the line from portfolio to direct investment. That will vary with each different type of business structure, and each different investment within that structure.

Ten per cent ownership by a single foreign entity has been cited as a clear line of division that a number have tried to turn to recently. Ten per cent ownership is used by the IMF, the OECD, the United States and many others as a statistical dividing line for investment statistics. As such, it may give a reasonable picture of investment stock and flows, portfolio and direct, but for policy and legal purposes, it is too arbitrary. There have been cases where a 5% holding was enough to give control over certain major decisions about an enterprise, and therefore conferred direct investor status. The single "golden share" held after some privatizations also gives rights to the holder over certain major decisions, and therefore must be considered more than a portfolio investment; i.e., a direct investment.

In addition, it is not always so easy to identify a given percentage of ownership. In a straightforward stock ownership situation it may be easy, but how about a large partnership, or the debt example given above? Many business structures are more complex than simple and straightforward stock ownership. A better approach is to ask whether the investor has a say in the running of the business.

Thus, portfolio and direct investment are firmly integrated, with one flowing into the other at the margin. What is done to one will affect the other. Although policy approaches should take into account the differing considerations arising under the two forms of investment, a policy that liberalizes one while trying to keep the other out will negatively affect both.

Conclusion

To characterise portfolio investment as "bad" and direct investment as "good" oversimplifies a much more complex situation. Both bring risks, and both require their own policy approaches. There seems to be a certain fear attached to foreign portfolio investment, due perhaps to its complexity and the central economic role of the financial system. (At one time there was fear of foreign direct investment too.) Does *foreign* portfolio investment engender greater concern? Certainly, financial disturbances have not been confined to foreign investors.

If you take "foreign" out of foreign portfolio or direct investment, most policy makers would acknowledge that domestic portfolio and direct investment are both necessary for healthy economic growth and development. Portfolio investment and the financial system it is a part of are central to any healthy economy. Put "foreign" back in and you have effectively increased the quantity and diversity of investment to even greater effect. As shown above, both portfolio and direct investment can bring powerful benefits to the economy, and together the benefits are increased.

The best answer is not to shut either type of investment out – not to label one "bad" and the other "good." Instead, both should be welcomed within the proper regulatory structure to maximize the benefits, and to manage the drawbacks and potential negatives. Both portfolio and direct investment bring value for economic growth. They are not intrinsically good or bad, but they are different. Liberalize both with respect for their differences.

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OFFICIAL DEVELOPMENT ASSISTANCE AND FOREIGN DIRECT INVESTMENT: IMPROVING THE SYNERGIES

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Official Development Assistance

In the ten years since Rio, progress has been made in improving the prospects of developing countries.[2] Inequality between the developed and the developing world has gradually begun to decline. At the beginning of the 1990s, for instance, the average real income in the countries containing the richest fifth of the world's population was eighteen times more than in those countries comprising the poorest fifth. At the close of the decade, the disparity had contracted to fourteen.[3]

Encouraging though this is, the statistics on human development globally still make for depressing reading. Currently, 1.2 billion people live on less than one US dollar per day and a further 1.6 billion on less than two. More than one billion people therefore cannot meet even the most basic consumption requirements, and some 840 million people on the planet are severely malnourished.[4] Nearly one billion adults are illiterate and more than 260 million school-aged children do not attend any form of schooling. Worse still, more than 250 million of them work as child labourers. Emphasising the link between the environment and development, some 60 per cent of the world's poorest people live in ecologically vulnerable areas. Furthermore, nearly three million people per year die from air pollution, and more than five million die of diarrhoeal disease caused by unsafe water supplies.[5]

The imperative to address these kinds of development problems is frequently cast in moral terms. There are, however, more utilitarian and self-interested reasons. The rising incidence of cross-border disease contagion, regional instability, environmental degradation and civil strife are all caused or exacerbated by poverty and have very real and direct implications for the developed world. At the same time, the tensions generated by the deterioration of 'ecological services' (like access to water or fish resources) may act as a catalyst for population displacement and may further worsen the poverty spiral. Poverty, combined with the collapse of governance as the events of 11 September 2001 showed all too clearly, can be a catalyst for international terrorism and other crimes such as narco-trafficking and money laundering. All of these issues impinge on the daily lives of those in the developed world and provide a justification, not only to help others, but also, by extension, to help themselves.

In 1969, the Pearson Commission, called on the industrialised countries to provide 0.7 per cent of their gross national product as official development assistance. More recently, many developed countries re-affirmed this target through the Millennium Development Goals.[6] The Zedillo Report on Financing for Development, which prepared the ground for the Monterrey Conference on Financing for Development, concluded that the "inescapable bottom line is that much more funding is needed for official development assistance." In this context, the same report called on developed countries to "implement the aid target of 0.7 per cent of GNP".[7] Indeed, the Zedillo Report concludes that the Pearson target is one on which the 22 OECD DAC members have essentially reneged for nearly 30 years. It is hard to disagree. Only five of the DAC membership actually achieved the Pearson target in 2000. The United States disbursed 0.1 per cent of GNP the lowest GNP/ODA ratio of any OECD DAC member. Two of the other major G-7 economies, Germany and Japan, gave just 0.26 per cent and 0.35 per cent respectively in 1999 and 0.27 per cent and 0.28 per cent in 2000.[8] More specifically, in 1992 the year of the Rio Summit, ODA amounted to $60.8 billion.[9] In 2000, the same figure was US$53.7 billion, representing a fall of 7 per cent in real terms.[10]

If every country contributed 0.7 per cent of their gross national product as ODA, nearly US$160 billion would be released.[11] Certainly, if the DAC membership was prepared to pay this additional US$115 billion in the form of ODA and meet the Pearson Commission's targets, it might be possible, at the very least, to pay for a number of global public goods. This, in turn, would undoubtedly assist in what the Zedillo Report calls the "take-off of developing countries".[12] The reality is, however, that there is little prospect of even a majority of the DAC membership meeting the Pearson commitments any time soon.

ODA Trends

A closer examination of the direction some of the funding from the larger donors is flowing indicates that the actual recipients of significant levels of assistance are relatively few. The top three recipients (Israel, Russia and Egypt) of U.S. assistance in 1999, for instance, accounted for nearly one third of all US assistance that year. The sums provided (US$1.1 billion, US$905 million and US$845 million respectively dwarfed the contributions made to the fourth and fifth placed recipient countries, Ukraine and Bosnia-Herzegovina, which received US$229 and US$218 million respectively.[13]

There are also serious questions about the directions in which ODA flows. Currently, very little ODA actually reaches the poorest countries. In 1999 and 2000, for instance, only 0.10 per cent of the average GNP of the 22 members of the OECD DAC actually found its way to low income countries and a mere 0.05 per cent flowed to the least developed countries.[14] Indeed, over the past decade, a number of DAC members introduced assessments of aid effectiveness which concluded that ODA was working effectively for certain countries, but not others. The consequences were significant. Many least developed economies suffered cuts in ODA flows of nearly 25 per cent over the period and seven African countries lost more than half of their ODA support.[15] Compounding this problem has been an apparent decline in interest by donor countries in assistance for environmental protection and basic social services. When taken together these two areas accounted for less than 12 per cent of all ODA in 1999.[16]

Another question frequently raised about donors relates to the effectiveness and quality of the assistance provided. Studies have suggested that a considerable proportion of development assistance provided by many of the G-7 and middle-sized DAC economies acts primarily as a foreign and commercial policy lever. Similarly, the use of export credit agencies, particularly by G-7 members, has been controversial because of their environmental and social impacts. The allocation and quality of assistance provided by many, if not all, of the smaller donor countries, on the other hand, is generally believed to be shaped by concern for the development needs of recipients.[17]

In the context of declining aid flows of dubious development effectiveness, there are also signs that some of the most generous countries appear to be having second thoughts. The new government in Denmark, for instance, is making cuts to its ODA, which currently stands at over 1 per cent of GNP.[18]

Against this background, it is also worth noting that even existing aid flows are increasingly premised on the establishment of effective governance and economic management by developing countries and the emergence of, for instance, a range of effective national sectorally-based strategies (e.g. for health or education).[19] The stringent requirements spelt out in the recent WHO Commission on Macroeconomics and Health, for instance, make it clear that there is nothing automatic about continued flows of development assistance.[20] In short, aid disbursements depend on significant policy and institutional improvements in developing countries.

The political reality that ODA is not only limited but is also in decline has already begun to filter into international discussions on the subject. Notwithstanding the US and EU initiatives[21] to expand ODA over time, the Pearson target will not be met any time soon. Furthermore, the much vaunted Monterrey Financing for Development Ministerial statement remains a relatively insipid document. It merely recognises that "a substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals and objectives". Significantly, it does not endorse the Pearson Commission targets, nor does it offer any support for UN Secretary-General Kofi Annan's call for doubling ODA from US$50 billion to US$100 billion per year.[22]

ODA the traditional response to facilitating growth in developing countries, particularly when it is under intense pressure, appears unlikely therefore to deliver on the scale or at the speed that is required to improve conditions in developing countries. Consequently, pinning international hopes on development with an increase in taxpayers' funds seems increasingly futile. How can governments then intervene swiftly and effectively for the better?

Foreign Direct Investment

One of the transmission mechanisms, which may help improve the dismal situation described earlier, is private investment. Empirical research of inter-country differences in growth rates suggests that there is a strong relationship between high investment rates and strong growth.[23] Furthermore, many of the most important decisions that will affect the fate of the world's forests, oceans, freshwater, and climate – and determine the development prospects of billions of people – are already being made by trans-national corporations and investors. Indeed, the OECD Guidelines for multinational enterprises (MNEs) acknowledge this precise point and support the potential for positive contributions to societies in which MNEs operate.[24]

There is an enormous literature on the benefits that FDI confers on the recipient country. The main aspects can be summarised as follows:[25]

- *Capital*: FDI brings in financial resources and these are more stable and easier to service than commercial debt or portfolio investments.

- *Skills:* FDI can attract and support the transference of managerial skills and advanced technical know-how. Improved and adaptable skills and new organisational techniques and management practices can yield competitive benefits for developing country economies as well as help sustain employment as economic and technological conditions change.

- *Technology:* Highly prized by developing economies, particularly when modern technologies are not available in the absence of FDI. Technology can also assist in raising the efficiency with which existing technologies are used and may spawn the establishment of local Research and Development facilities.

- *Market access*: FDI through the activities of trans-nationals can provide improved access to export markets both for goods and services that are already produced in developing countries, helping them switch from domestic-only production to international markets. Export expansion offers multiplier benefits in terms of technological learning, realisation of economies of scale, competitive stimulus and market intelligence.

- *Environment*: foreign companies investing in developing countries are frequently leaders in the development of clean technologies and modern environmental management systems. They can employ such mechanism in the developing countries in which they operate. Spillovers of technologies and management experience and skills can enhance environmental management in local companies within the industries where foreign investment is present

There is no doubt that FDI is sought by developing countries as a means of complementing levels of domestic investment, as well as securing economy-wide efficiency gains through the transfer of management know-how, technology, business practice, access to foreign markets, increased employment opportunities, and enhanced living and environmental standards.

The raw figures are striking, particularly when set against the increasingly anaemic ODA data. At the time of the Rio Conference in 1992, FDI flows to developing countries stood at around US$36 billion. By 1999, this figure had more than quadrupled to nearly US$160 billion.[26] Buttressing this evidence, a study of the ASEAN-5 economies concluded that FDI played a "significant role" in augmenting growth. Using a simple growth-accounting framework, the analysis demonstrated that FDI directly accounted for between 4 and 20 per cent of GDP growth between 1987 and 1997. Moreover, the same study noted that FDI flows were stabilising factors during the Asian financial crisis.[27] Systematic analysis undertaken by the World Bank and UNCTAD also indicates that the impact of FDI is, broadly speaking, positive. FDI to developing countries is either neutral (i.e. one dollar of FDI leads to investment growth of one dollar) or of the "crowding in" variety (i.e. total investment increases by more than the additional dollar of FDI).[28]

FDI Trends

It is also important to acknowledge that, while the overall FDI figures are large, a small number of developing countries are attracting the lion's share of investment. Seventy-five per cent of all global FDI flows go to developed countries, the remaining 25 per cent is unevenly spread, with relatively little trickling down to the least developed economies. In 1998, for instance, the entire African continent received barely 1 per cent of global flows.[29] Indeed, in 1999, sub-Saharan African countries received nearly 65 per cent of all their net external finance from ODA.[30] There has also been a tendency to favour particular countries with FDI flows. Ten middle-income developing countries, for instance, accounted for nearly 80 per cent of all FDI received by developing countries in the past decade. China alone has bagged US$321 billion or 45 per cent of all of the investment flowing to the Asian region since 1990. This has significant implications for the wider region.[31]

It may also be worth reflecting on the longer historical perspective of FDI flows. In 1914, at the end of what has been described as a 'previous phase of globalisation', nearly 40 per cent of western European FDI flows found their way to Latin America, Asia and Africa. In the 1990s, less than half that amount found its way to those regions. In short, western European FDI flows were more globally oriented at the beginning of the last century than at its close.[32]

In a bid to ensure a better spread of FDI flows, many developing countries have undertaken reform programmes designed to attract ongoing and expanded external investment. The need to address potentially long-standing structural weakness, which can affect the long-term stability of flows, is important, and the sequencing of reforms remains critical. The experience of Argentina is salutary. Argentina opened itself to foreign capital and received enormous inflows of direct investment – almost US$80 billion from 1991 to 2000. Foreign companies invested heavily in oil, telecommunications and banking industries. But the resulting economic gains were ultimately offset by long-standing weaknesses, including, chronic government deficits, tax evasion, a weak entrepreneurial class and an uncompetitive wage structure, all of which led to the catastrophic events of late last year.

At the other extreme are those developing countries that consciously strive to attract foreign investment, but fail to do so. The Kyrgyz Republic is a case in point. It was the first CIS member to join the WTO. It was also the first former Soviet Republic to initiate broad-based efforts to re-vamp its bureaucracy, implement competition and tax policies favourable to foreign investors and install policies designed to encourage domestic savings and strengthen the local infrastructure. This was not sufficient. FDI flows since independence have been limited. In the absence of any natural resource wealth and the negligible and poor consumer market, investors flocked to the neighbouring Central Asian Republics which have yet to join the WTO and have not undertaken anywhere near the same level of reform as the Kyrgyz Republic. Thus, less than 10 per cent of total FDI flows directed at the Central Asian region went to the Kyrgyz Republic. Uzbekistan, Kazakhstan and Turkmenistan attracted nearly 85 per cent of all FDI flows to the region with war-torn Tajikistan absorbing the remainder.

In sum, FDI flows can supplement domestic financial resources for development and add directly or indirectly to domestic investment in developing countries. They bring in much needed foreign exchange that improves a host country's balance of payments. There is also evidence that FDI flows are generally neutral and can 'crowd in' further investment. It is not surprising then that most developing countries regard FDI as critically important to their national development strategies. Nevertheless, while all developing countries try to attract FDI, such inflows are unevenly distributed. Furthermore, despite its rapid growth, the extent of investment in developing country markets has been insufficient to meet demand: an estimated 3.5 billion people world-wide, for instance, still do not have access to basic infrastructure services.

Box 1*

The case of the N4 toll road between South Africa and Mozambique is a good illustration of what can be achieved when investors and ODA agencies work together. The N4 toll road was a significant component of a major economic development initiative called the "Maputo Corridor programme". At the heart of the corridor was the need for a 440km strong road link connecting Maputo with Johannesburg. Both Governments sought private capital to fund these projects. At first, private financing was difficult to secure. The tendering process was unclear, legal mechanisms were opaque, land ownership questions surrounding the road link were of concern and most importantly, private investors doubted the effectiveness of the co-ordination efforts of the two countries involved. To facilitate private sector interest, the Danish Development Agency and the World Bank provided modest funding for the requisite technical advice in designing the framework structures required, including in particular the establishment of a bi-national Implementation Authority which developed the most attractive investment alternative. This has been identified as the "central reason" behind the scheme's success. Following the establishment of the bi-national commission and transparent and reliable tendering procedures, private investors provided all of the requisite funding for the road link and, indeed for the wider rehabilitation of the rail link between the two cities.

* Sader, F., (2000) *Attracting Foreign Direct Investment into Infrastructure: Why is it so Difficult?* Occasional Paper 12, World Bank, Washington, pp. 90-100.

Against this background, it may be possible to argue that declining aid flows are compensated in part by relatively greater private investment flows as has happened in a minority of middle-income developing countries. Low-income developing and least developed countries, however, have been *unable* to benefit from private capital flows as they continue to be relatively unattractive to investors. As a consequence, these countries are becoming increasingly dependent on aid, and reductions in the provisions of public capital flows have a concomitantly negative effect on these countries. Indeed, it is worth emphasising that for these countries an increase in ODA funding is an urgent and pressing need.

In short, the answer to the question posed at the beginning of this paper, whether FDI can fill the gaps created by declining aid flows, is highly qualified. Given declining ODA funds, it becomes imperative to improve their quality such that they can leverage and stabilise FDI flows.

Creating synergies between ODA and FDI

Box 2.*

Land degradation is a severe problem in the Ethiopian highlands where soil erosion has been estimated to average 42 tonnes per hectare. At the same time, this region is one of growing significance for the country's nascent coffee growing sector. In 1997-98 foreign investors expressed interest in working with local authorities in the region to develop coffee production. The problem remained, however, the unsustainability of land management practices. In a bid to encourage private sector engagement, the Norwegian and Swiss Development Agencies provided technical assistance to help improve the sustainable management of agriculture in the region. Additionally, legal assistance was provided to improve the land registration process, a factor identified by the private company as critical for its long-term strategy. As a direct consequence of the technical assistance, which helped improve the sustainability of the yield and agricultural techniques, the company has now invested heavily in the region. Coffee production for export began in 2000.

* For more details see, Pender, J., Gebrenedhin, B., Benin, S. and Ehui, S., (2001) *Strategies for Sustainable Agricultural Development in the Ethiopian Highlands*, American Journal of Agricultural Economics 83 (5), pp. 1231-1240 and Pender, J., Place, F., and Ehui, S., (1999) *Degradation and Conservation of Resources in the East African Highlands* EPTD Discussion Paper 41, IFPRI, Washington.

There is an enormous literature on ways to improve the effectiveness of FDI flows to developing countries. One idea has been to improve the synergies between such flows and ODA. There is evidence that carefully targeted development assistance may assist in leveraging FDI flows and creating a virtuous circle of increasing savings and investment. Most significantly, such a situation can be created when ODA is used to buttress or develop institutions and policies in developing countries. This helps create a favourable environment for (domestic) savings, (domestic and foreign) investment and growth. More specifically, ODA funds can be used to support those areas considered important to investors in determining investment decisions. Some donor and recipient countries have been working for some time along these lines, though for many DAC members, practical implementation has been relatively recent. Boxes 1 and 2 provide practical examples of the development of synergies between FDI and ODA.

Another approach being pioneered by some donors and, in particular, the World Bank is the concept of *output-based aid*. Donor countries and developing countries are increasingly interested in using this mechanism where, *inter alia*, "quasi-contracts" are established between government agencies and the private sector to deliver specific services. The responsibility for the delivery of such services is thus transferred to private investors/providers. In contrast with the more traditional approaches to ODA delivery, this mechanism begins at the outset with a definition of objectives and specifies expected performance in terms of very clear outputs (or outcomes), rather than focussing on inputs.[33] The relatively recent experience with such schemes has provided important insights into output-based approaches as a way of improving the delivery of services, while at the same time better targeting government and donor funds. More generally, schemes for private participation in infrastructure, aimed at mobilising private incentives for innovation and efficiency in the delivery of services have expanded considerably with broadly positive results. Research undertaken recently, for instance, suggests that this approach has yielded significant welfare effects. At the same time, however, the benefits of leveraging private investment and its effects on distribution are sensitive to the way in which contracts are conceived and the pace and extent of market structures and policy reforms.[34]

When considering whether/how ODA policies might help generate FDI flows, one of the issues to consider is: what are the main impediments the private sector perceives in host countries, which could be affected by such judicious policies?

Judging from the World Bank's survey of business attitudes on investment decisions[35] and the more recent World Business Council on Sustainable Development paper (WBCSD)[36] on a similar theme, the main issues include:

- corporate governance (corruption, transparency);
- social and economic stability;
- transparent and reliable administrative processes;
- fair taxation and competition policies; and
- socio-economic issues (including human rights and security).

Mozambique is a specific example of a country which, following the conclusion of its civil war, consciously focussed its reform programme on many of the issues identified in the two surveys cited above. Working with the UK Department for International Development and the Portuguese Development Agency, Mozambique has enjoyed considerable success. There has been a six-fold increase in FDI since 1994, much of it directly attributable to the efforts made by the government to respond to the concerns of foreign investors about governance, transparency issues and domestic macro-economic policies.[37]

Many other developing country governments already try to address the kinds of issues identified by the World Bank and WBCSD through their domestic reform programmes. More specifically, many seek to adhere to a range of codes and standards which are internationally recognised as indicators of good practice for responsible and transparent behaviour in the financial and corporate sectors (see Appendix for an outline of the 12 Key Standards for Sound Financial Systems). The implementation of these codes can certainly persuade investors that the environment is supportive for FDI flows, though companies continue to have concerns about the relevance of some of these codes to implementation and practice on the ground.[38] At the same time, from the perspective of developing countries, such activities require considerable resources and technical knowledge to implement and this may be another area for ODA Agencies to consider supporting in a bid to leverage FDI.

Conclusion

Traditional approaches to aid and spending have often failed to yield sustained improvements in economic development, particularly for the least developed economies. FDI flows are also too unevenly spread to allow one to conclude that such a mechanism alone can fill the gap created by declining ODA levels. Thus, in a world of declining aid budgets, an increasingly critical question for developing countries and donor countries is how to leverage private financing with public resources. Internationally, there is increased understanding that good framework conditions can help attract and retain FDI flows. At the same time, there is also evidence that the use of ODA in a consciously targeted manner to try and attract and retain such flows may improve the efficiency and effectiveness of such forms of assistance.

The Monterey Conference on Financing for Development and the WSSD ensured that the issue of declining ODA flows will again be at centre stage internationally. The central question posed by this paper was whether it was possible to make up the difference by relying on private investment. For most developing countries, the conclusion is that private investment flows are insufficient and synergies between ODA and FDI need to be improved.

Against this background there are some modest, but potentially workable ways in which to help improve the synergies between ODA and FDI:

- *Information Sharing:* between companies working in a developing country and the ODA agencies considering releasing funds in support of a particular economic sector. One area of interest to ODA agencies, for instance, may be information (shorn of its commercial sensitivity), which can give them a better sense of the real state of the economy (e.g. the relationship between the formal and informal economy); and

- *Formalised Dialogue:* Is there scope for a formalised dialogue (as opposed to simply information sharing) between ODA agencies and businesses? One idea might be to have this exchange occur at regular intervals on several levels, i.e. sub-national, national, sub regional, regional etc. Such discussions should involve all layers of staff involved-not simply at the political level, but also at the on-the-ground working level.

NOTES

1. Mehmet Ögütçü presented the theme in the conference based largely on this paper. For further information please contact Mr. Vangelis Vitalis at the OECD, 2 rue André Pascal, 75016 Paris, tel: +33 1 45 24 14 57; fax: +33 1 45 24 79 31; email: Vangelis.Vitalis@oecd.org. The views expressed in this paper do not necessarily represent those of the OECD or any of its Member countries.

2. OECD (2001*a*), *The DAC Guidelines on Poverty Reduction*, OECD, Paris.

3. The 1960 and 1990 figures are derived from The United Nations Council for Trade and Development (1996) *Report on Least Developed Countries*, United Nations, New York. The 1999 figure has been estimated by the author using adjusted World Bank (2000) data. Figures cited are based on a comparison of purchasing power parity. The results are comparable to (though lower than) other analyses, e.g. DFID (2000) *Eliminating World Poverty: Making Globalisation Work for the Poor, White Paper*, UK DFID, London (also: http://www.globalisation.gov.uk).

4. OECD (2001*b), The DAC Journal: Development Co-operation 2000 Report*, OECD, Paris.

5. United Nations Development Programme (1999), *Human Development Report*, UNDP, New York.

6. See http://www.un.org/News/Press/docs/2001/pi1380.doc.htm.

7. High Level Panel on Financing for Development (2001), *High Level Panel Report on Financing for Development*, United Nations, New York, June.

8. OECD (2001*b* and 2002 forthcoming). Only Norway, the Netherlands, Sweden and Denmark met the 0.7 per cent target in 1999. Luxembourg joined this group in 2000.

9. OECD (2002), *The DAC Journal: Development Co-operation 2001 Report,* OECD, Paris (forthcoming).

10. Idem.

11. Author's calculations adjusted to current prices and exchange rates, based on data from OECD (idem).

12. High Level Panel on Financing for Development (ibid).

13. OECD (2001*b*).

14. Low income countries are those with a per capita income of US$760 or less in 1998. Least developed countries are countries on the UN's 2000 list of that name.

15. Executive Committee on Economic and Social Affairs of the United Nations Secretariat (2001) *Towards a New Aid Compact* (ECESA/01/1), United Nations, New York, 20 June, Table 3. See also http://www.un.org/esa/coordination/ecesa/ec-statm.htm.

16. Commission for Sustainable Development (2001), *Financial Flows Statistics*, United Nations Department of Economics and Social Affairs, Background Paper Number 19, April.

17. Hjertholm, P., and White, H., (2000) *Survey of Foreign Aid: History Trends and Allocation,* Institute of Economics, University of Copenhagen, Discussion Paper, March.

18. Ironically, while the cuts proposed by Denmark are not insignificant, they will still easily meet the 0.7 per cent target and are still likely to remain among the top three ODA providers in the OECD DAC.

19. A useful summary of the main issues is contained in OECD (2001), *ODA Demand and Supply: Current Perspectives* [DCD/DAC(2001)29/REV2].

20. WHO (2001) *Macroeconomics and Health: Investing in Health for Economic Development*, WHO, Geneva.

21. At Monterrey developed economies committed to increasing their ODA. Taken together these would raise overall ODA flows in real terms by about US$13 billion by 2006 from US$53.7 billion in 2000. The Economist (23 March 2002) provides a useful overview of both initiatives.

22. A final unedited version of the Monterey Consensus is available at http://www.un.org/ffd.

23. See for instance, UNCTAD (1999), *Foreign Direct Investment and the Challenge of Development*, United Nations, New York and the seminal analysis by Barro, R.J. and X., Salai-I-Martin (1995) *Economic Growth*, New York, McGraw Hill.

24. The Guidelines are part of a broader OECD investment instrument: the Declaration on International Investment and Multinational Enterprises. The Recommendations contained in the Guidelines' text provide guidance on appropriate business conduct across the full range of MNE activities. They are supported by implementation procedures in the participating countries, which comprise all 30 OECD member countries, and three non-member countries (Argentina, Brazil and Chile). Further information can be found in OECD (2001) *The OECD Guidelines for Multinational Enterprises*, OECD, Paris. The Guidelines can be accessed at the following site: http://www.oecd.org/pdf/M000015000/M00015419.pdf.

25. See, in particular, OECD (2002) *Benefits and Costs of FDI for Development* (forthcoming) which provides a comprehensive and up-to-date survey of the evidence.

26. The figures cited are drawn from UNCTAD (1996), *Report on Least Developed Countries,* United Nations, New York and IMF (2000) *World Economic Outlook*, Washington MF (2000).

27. Fan, X. and Dickie, P.M., (2000), *The Contribution of Foreign Direct Investment to Growth and Stability,* ASEAN Economic Bulletin, December.

28. The general consensus in the academic literature is that, while "crowding out" cannot be ruled out, this does not appear to be a common feature of investment patterns in most developing countries. UNCTAD's (1999) results should be used with caution, however. The variables used, as the report acknowledges, are far from perfect (e.g. FDI flows underestimate the total value of investment of foreign affiliates), there are secondary effects which are impossible to quantify and there remains no consensus on which methodology to apply in such analyses.

29. UNCTAD (1999).

30. World Bank (2000) Global Development Finance, World Bank, Washington.

31. Idem.

32. Madison, A., (1995) *Monitoring the World Economy 1820-1992*, OECD, Paris (Table 3.30). Please note, in this example, “western Europe” comprises the United Kingdom, France, Germany, Belgium, the Netherlands and Switzerland.

33. For a summary of the principles and concepts behind output-based aid see Brook, P.J and Petrie, M., (eds) (2002) *Contracting for Public Services: Output-Based Aid and its Applications*, World Bank, Washington.

34. Some of the opportunities and challenges thrown up by this approach are explored in some detail in OECD (1999) *Performance Contracting: Lessons from Performance Contracting Case Studies and A Framework for Public Sector Performance Contracting,* OECD PUMA, Paris.

35. World Bank (1997) *World Development Report*, World Bank, Washington and www1.worldbank.org/beext/part_ii_csai_Maina_WBES.htm

36. WBCSD (2002) *Improving Synergy Flows Between ODA and FDI to Developing Countries: A Business Perspective*, Paper prepared for OECD Round Table on Sustainable Development (available at http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-21-nodirectorate-no-21-8909-21,FF.html).

37. DFID (ibid) see chapter four, Harnessing Private Finance (para. 157) and Brook, P.J. and Petrie, M., (eds) (2002) *Contracting for Public Services: Output-Based Aid and its Applications,* World Bank, Washington.

38. World Bank (1997, ibid).

APPENDIX

List of the 12 Key Standards for Sound Financial Systems

Macroeconomic policy and data transparency

Code of Good Practices on Transparency in Monetary and Financial Policies (IMF): www.imf.org

Code of Good Practices on Fiscal Transparency (IMF): www.imf.org

Special Data Dissemination Standard (SDDS)/General Data Dissemination System (GDDS): www.imf.org

Institutional and market infrastructure

Principles and Guidelines for Effective Insolvency and Creditor Rights Systems: www.worldbank.org

Principles of Corporate Governance (OECD): www.oecd.org

International Accounting Standards (IASB): www.iasb.org.uk

International Standards on Auditing (IFAC): www.ifac.org

Core Principles for Systemic Important Payment Systems (CPSS): www.bis.org

The Forty Recommendations of the Financial Action Task Force on Money Laundering (FAFT): www.oecd.org/fatf

Financial regulation and supervision

Core Principles for Effective Banking Supervision (BCBS): www.bis.org

Objectives and Principles of Securities Regulation (IOSCO): www.iosco.org

Insurance Core Principles (IAIS): www.iaisweb.org

Part V

COUNTRY/REGION SUBMISSIONS

CHILE'S FDI POLICY: PAST EXPERIENCE AND FUTURE CHALLENGES[1]

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Building a track record

Chile is widely recognized for its success in attracting FDI. Between 1974 and 2000, materialised foreign investment totalled US$52.4 billion. Of this amount, 83.4% entered the country after 1990. During the 1990s, FDI accounted for 6.4% of Chile's GDP on an annual average, rising to 8.3% between 1995 and 2000.

FDI flows worldwide increased dramatically during the 1990s,[2] when they expanded by a factor of 4.3.[3] Although high-income countries were the main recipients, the share of low- and middle-income countries in global FDI increased from 12% in 1990 to 21% in 1999 (of which Latin America received almost half).

In this scenario, Chile has recorded a notable performance. Between 1990 and 1999, FDI increased by a factor of 15.2 and the country's share of FDI in low- and middle-income countries doubled from 2.5% in 1990 to 5% in 1999. Chile received 10% of all FDI in Latin America in 1999, although its GDP represents only 3.6% of regional output and it has only 3% of the region's population.

Table 1 sets out figures for performance by country, including Latin American and East Asian countries that have been characterized by high economic growth or policies that favour foreign investment. The table shows that, in the 1990s, some Latin American countries began to show FDI/GDP ratios that were similar to those of successful East Asian economies (notably Singapore). By the end of the decade, Trinidad and Tobago, Bolivia, Nicaragua, Chile and Panama all had FDI inflows that were equivalent to between 7% and 9% of GDP.

Comparisons of FDI/GDP ratios across countries can be misleading, since small economies register higher ratios than large economies. Figure 1 sets out FDI/GDP ratios, corrected for the effect of country size, and confirms that small countries (with size measured by GDP) tend to have a higher ratio than large countries.

By taking the best-performing countries at each income level, we can obtain an approximation to an "efficiency frontier" i.e. the highest level of FDI/GDP that a country can expect to attain, given the size of its economy. In Figure 1, this "frontier" appears as a straight line and the data shows that only Chile and Singapore crossed the "frontier". In other words, when the figures are corrected for country size, Chile and Singapore are seen to have outperformed all other countries between 1995 and 1999 in attracting FDI.

Table 1. Ratio FDI to GDP
(percentages)

	1980-84	1985-89	1990-94	1995-99
Latin American Countries				
Argentina	0.5%	0.8%	1.4%	3.6%
Bolivia	1.2%	0.1%	1.5%	9.0%
Brazil	0.9%	0.5%	0.4%	2.6%
Chile	0.9%	1.5%	2.8%	7.7%
Colombia	1.1%	1.5%	1.5%	2.8%
Costa Rica	1.3%	1.5%	2.6%	3.7%
Dominican Republic	0.7%	1.3%	2.0%	3.8%
Ecuador	0.4%	0.7%	2.1%	3.2%
El Salvador	0.2%	0.4%	0.2%	2.4%
Guatemala	0.9%	1.8%	0.8%	1.2%
Honduras	0.4%	1.0%	1.3%	2.4%
Jamaica	n.a.	0.4%	3.2%	4.6%
Mexico	0.7%	1.3%	1.5%	2.9%
Nicaragua	n.a.	n.a.	1.0%	7.9%
Panama	0.1%	0.1%	2.8%	7.2%
Paraguay	0.4%	0.1%	1.5%	1.6%
Peru	0.1%	0.2%	1.9%	4.0%
Trinidad y Tobago	2.5%	1.0%	5.5%	10.0%
Uruguay	0.7%	0.4%	0.3%	0.8%
Venezuela	0.2%	0.2%	1.5%	3.7%
South-East Asian Countries				
Indonesia	0.2%	0.5%	1.2%	1.0%
Korea, Rep.	0.1%	0.4%	0.3%	1.1%
Malaysia	4.0%	2.3%	7.1%	4.0%
Singapore	9.3%	10.7%	10.3%	8.4%
Thailand	0.8%	1.2%	1.8%	3.3%
Vietnam	6.0%	6.5%	7.5%	7.1%

Source: World Bank (2001)

Figure 1
FDI over GDP by level of GDP

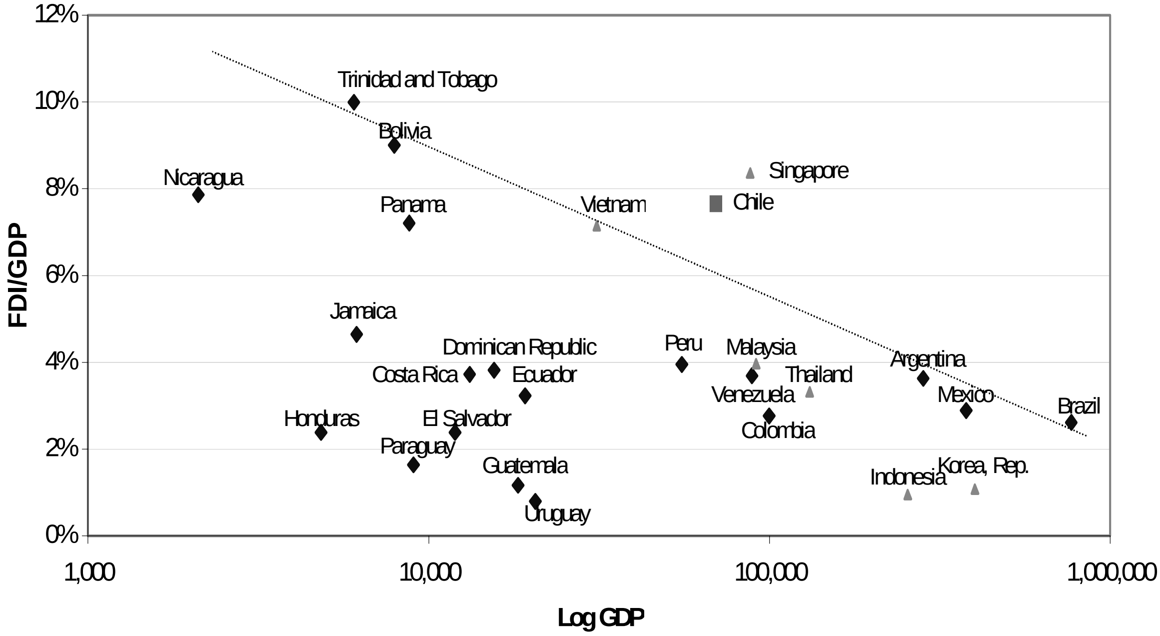


Figure 2
Foreign Investment Statute (DL 600)
Investment by Sector 1974-2000

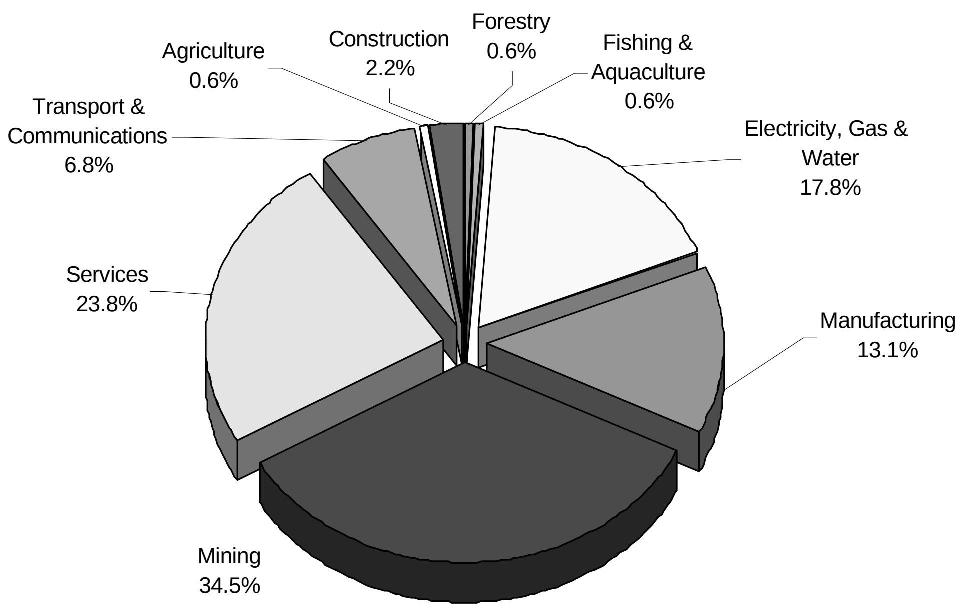


Figure 3
Foreign Investment Statute (DL 600)
Distribution of Materialized FDI by Sector

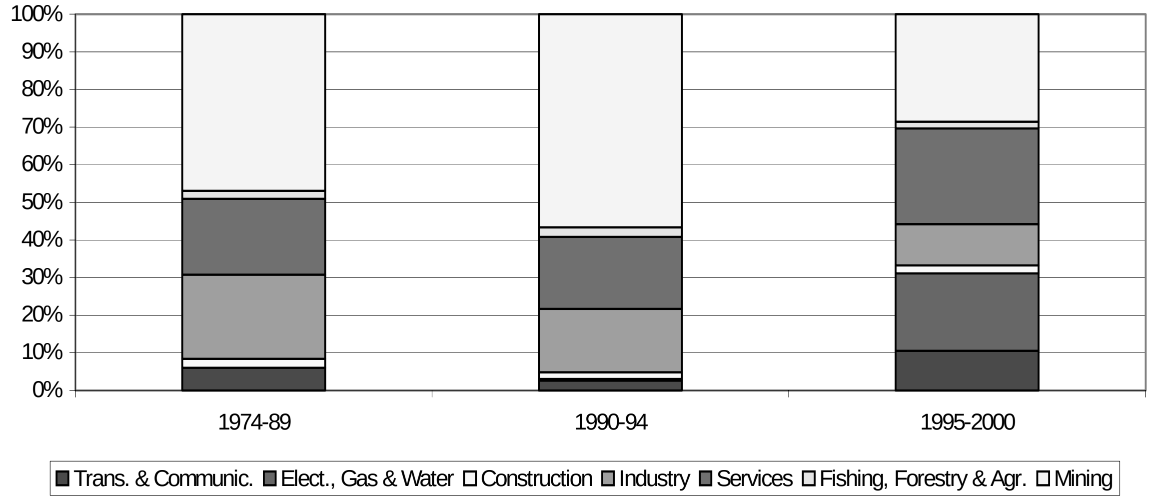
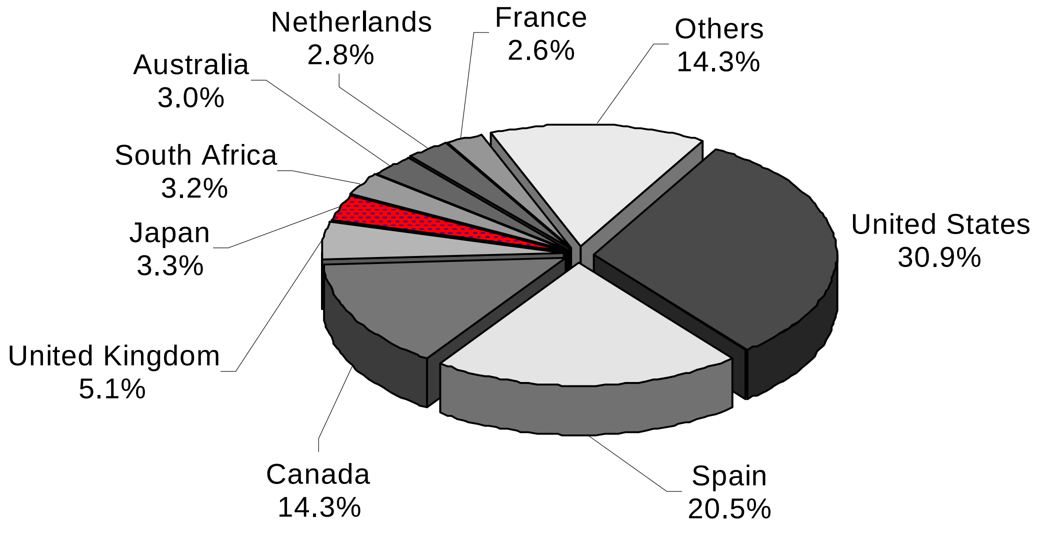


Figure 4
Foreign Investment Statute (DL 600)
Investment by Country of Origin



Distribution by sector and country of origin[4]

Between 1974 and 2000, the mining industry accounted for 34.5% of foreign investment in Chile. As shown in Figure 2, it was followed by the services sector (23.8%), the electricity, gas and water industries (17.8%) and manufacturing (13.1%).

Until 1990, mining projects represented 47% of DL 600 investment, boosted by the government's decision to lift restrictions on private investment in the exploration and exploitation of mineral deposits. Similarly, investment in financial services was encouraged by the deregulation of the financial sector. Since 1990, however, other sectors have gained in importance and the mining industry's share of DL 600 investment gradually diminished to an average 28.5% in 2000 and 2001.

As shown in Figure 3, the decrease in the relative importance of mining was counterbalanced mainly by higher investment in the transport and communications industries (including telecommunications) and in the electricity, gas and water sectors. This new trend was mainly the result of privatizations in the energy and telecommunications sectors and of the intense competition that followed the deregulation of mobile and long-distance telephone services.

In addition, an Infrastructure Concessions program, launched in 1993, opened the way for the participation of private capital, mostly from abroad, in the construction and operation of roads and airports.

As from 1997, there has been a surge of M&A activity, mainly in the services, electricity and telecommunications industries, owing partly to foreign companies' interest in using Chile as a platform for expansion into other Latin American countries. Water privatizations and a concessions program for water treatment services have also captured important inflows of FDI in recent years.

Regarding sources of FDI, between 1974 and 2000, 30.9% of DL 600 investments in Chile originated in the United States, followed by Spain (20.5%), Canada (14.3%), the United Kingdom (5.1%) and Japan (3.3%). As a group, the OECD countries account for 90% of the DL 600 investments that have been carried out in Chile (see Figure 4).

FDI in Chile: regulatory framework

Chile has several competitive advantages that make it an attractive location for foreign corporations looking to develop new business and to expand in Latin America. One of the country's most valuable assets is its stable and transparent policy framework for foreign investment, embodied both in the 1980 Political Constitution and in the Foreign Investment Statute, known as Decree Law 600 (DL 600).

Inflow Mechanisms

Since 1974, when the Foreign Investment Statute (DL 600) came into force, the vast majority of foreign investors have chosen to use this mechanism. Under DL 600, an investor signs a legally binding contract with the State for the implementation of an individual project and, in return, receives a number of specific guarantees and rights that are explained below. Between 1974 and 2000, investments worth US$43.8 billion, representing 84% of the total FDI inflow, used this mechanism.

However, a simpler investment mechanism, Chapter XIV of the Central Bank's Compendium of Foreign Exchange Regulations (CFER), also exists. Under this mechanism, FDI need only comply with registration procedures. However, Chapter XIV does not carry all the guarantees that are provided by DL 600.

A third mechanism, Chapter XIX of the Central Bank's Compendium of Foreign Exchange Regulations (CFER), played an important role between 1985 and 1991, when it was used for investments totalling US$3.6 billion, mainly in the manufacturing and services sectors. However, this debt conversion mechanism is no longer in operation.

Table 2. Foreign Direct Investment by Inflow Mechanism (Percentage of total)

Investment Mechanism	1974-2000	1998	1999	2000
Foreign Investment Statute (DL 600)	83.5	91.5	93.0	80.2
DL 600 Equity	62.0	67.3	88.1	68.5
DL 600 Associated Loans	21.5	24.4	4.9	11.7
Chapter XIV (CFER)	9.6	8.3	7.0	19.8
Chapter XIX (CFER)	6.9	-	-	-
TOTAL	100.0	100.0	100.0	100.0

Sources: Foreign Investment Committee (www.foreignvestment.cl), Central Bank of Chile (www.bcentral.cl)

Foreign Investors' Rights

Foreign investors in Chile can own up to 100% of a Chilean-based company, and there is no time limit on property rights. They also have access to all productive activities and sectors of the economy, except for a few restrictions in areas that include coastal trade, air transport and the mass media. In the case of fishing, restrictions are subject to the rules of international reciprocity.

The State has a very minor productive role in Chile. Only a few strategic activities – such as exploration and exploitation of lithium, liquid and gaseous hydrocarbons deposits in coastal waters under national jurisdiction or located in national security areas and the production of nuclear energy – are restricted to the State, although, under certain circumstances, foreign companies can invest even in these areas.

Under Chile's Constitution and its legal system, foreign investors are guaranteed non-discrimination. Whichever investment mechanism they use, foreign investors enjoy the same rights and guarantees as local investors and are assured of non-discretionary treatment by the State.

Any foreign individual or legal entity, as well as Chileans with residence abroad, can invest through DL 600. Under this mechanism, investors enter into a *legally binding contract* with the Chilean State, which cannot be modified unilaterally by the State or by subsequent changes in the law. However, investors may, at any time, request the amendment of the contract to increase the amount of the investment, change its purpose or assign its rights to another foreign investor.

DL 600 guarantees investors the right to repatriate capital one year after its entry and to remit profits at any time. In practice, the one-year capital lock-in has not represented a restraint since most productive projects require more than a one-year start-up period. Once all relevant taxes have been paid, investors are assured of access to freely convertible foreign currency without any limits on the amount, for both capital and profit remittances. In addition, they are guaranteed the right of access to the formal exchange market.

It should be noted that the Central Bank has the right to restrict access to the formal exchange market – made up by banks and other authorized dealers – if adverse macroeconomic conditions make this necessary. However, DL 600 investors are exempt from these restrictions and their right to access the market in order to repatriate profits or capital is not affected.

Some projects – whether carried out by foreign or local investors – require specific authorization from relevant authorities. The authorization of The Chilean Commission of Copper is, for example, required for investments in mining, while the Under-secretariat of Fishing must approve fishing investments. Similarly, the consent of the Banks and Financial Institutions Regulatory Agency is required for investments in the banking sector and that of the Securities and Exchange Commission for the insurance industry and investment funds. A project's potential environmental impact is assessed through the Environmental Impact Evaluation System, a mechanism managed by the National Environment Commission.

All the rights guaranteed by Chile's legal framework are further protected by Bilateral Investment Treaties (BITs). As of December 2001, Chile had signed 50 BITs, 32 of which were already in force. In addition, Chile's Free Trade Agreements (FTAs) with Canada and Mexico include specific chapters on investment-related issues, including dispute-settlement mechanisms that are similar to those used in BITs.

Special Tax Advantages for Foreign Investors

Although Chile's Constitution is based on the principle of non-discrimination, DL 600 offers some tax advantages for foreign investors. These are not "tax breaks" or "tax holidays", but are intended to provide a stable tax horizon, acting as a form of "tax insurance". DL 600 offers several different tax options, but basically allows the investor to lock into the tax regime prevailing at the time an investment is made.

Invariability of Income Tax Regime: Under Chile's Common Tax Regime, a 35% tax is currently levied on distributed or remitted profits but, under DL 600, a foreign investor can opt to lock into a 42% tax on income for up to ten years. The investor, thereby, acquires immunity from any tax increases in the Common Tax Regime that may occur during that period. The lock-in can be waived at any time, but an investor cannot subsequently revert to the guaranteed 42% rate.

However, it should be noted that investors who do not remit or distribute profits are liable only for a 16% first-category tax.[5] If an investor subsequently remits profits, the first-category payment can be set against tax returns under both the Common Tax and Invariable Tax Regimes.

Invariability of Indirect Taxes: Foreign investors also have access to a regime that freezes Value Added Tax, as well as import tariffs on capital goods for the project, at the rate in force at the date of the investment. This special regime applies throughout the period authorized for carrying out the investment. Additionally, imports of some of these capital goods are exempt from VAT, if they are not produced in Chile and are on a list published by the Ministry of Economy.

Special Regime for Large Projects: DL 600 investments in new industrial or extractive activities, including mining, are entitled to additional tax benefits, providing they have a value of at least US$50 million. This special regime was introduced in 1985 to reduce tax uncertainty and facilitate the development of foreign investments requiring high levels of external credits and financing. Available for a period of up to 20 years, this regime allows an investor or recipient company to use accounting in foreign currency and to lock into existing practices on matters such as asset depreciation, carry-over of losses and the tax treatment of start-up expenses. In addition, because the regime was introduced at a time when exporters were still obliged to repatriate returns, it authorizes DL 600 investors to hold export returns in offshore accounts and offers a special tax arrangement for repatriated returns.

Direct Incentives and Subsidies

In line with its commitment to free-market economic policies and free trade, Chile does not use tax incentives to support productive activities or to attract new investment. However, it does provide certain inducements for investments in some isolated geographic regions and new industries, particularly those in the technology field.

Investors can, for example, tap into government schemes to promote workplace training and to increase industrial productivity. All these schemes, in the form of grants and tax rebates, are available equally to both local and foreign investors and are part of a wider government strategy designed to increase competitiveness by extending the benefits of economic growth to all areas of the country, promoting education and training and encouraging technological innovation.

All firms in Chile are allowed to set training costs of up to 1% of annual payroll against corporate tax payments and, in some remote areas, can also claim a tax rebate on labour costs and for some start-up expenses. Grants, which are managed mostly by the Chilean Economic Development Agency (CORFO), are limited in number and qualifying firms are selected on the basis of established criteria that reflect the government's development objectives.

In 2000, CORFO introduced a program of special incentives for investments in high-technology projects. As well as information technology and biotechnology, this covers projects that introduce new methods in traditional processes and new technology-based services. Both foreign and local investors in projects with a minimum value of US$1 million can apply for support under this program which offers grants towards pre-investment studies and the acquisition of fixed assets and staff training, as well as for R&D projects with a high commercial impact.

Chile's choice of FDI policy

All countries would like to benefit from positive externalities and spin-off effects of foreign investment. Along with an immediate impact on current account financing and job creation, foreign investment brings longer-term benefits in the form of technology transfer, increased export development, improved international integration and greater domestic competition.

As a result, countries are increasingly competing to attract FDI. This competition can come in many guises, but the literature distinguishes two main approaches – direct incentives, usually in the form of tax rebates and direct subsidies, and what Oman (2000) has termed the "beauty contest" approach.

Under a "beauty contest" strategy, a country does not offer direct incentives to foreign investors, but relies on its other competitive advantages to attract FDI. This approach usually involves (but is not limited to) upgrading infrastructure, strengthening macroeconomic fundamentals, increasing educational standards, guaranteeing the rule of law, and, in general, improving a country's "business climate".

Although a choice exists between the two options, it is a difficult one. Moreover, the two options are not mutually exclusive and some authors argue that direct incentives are always necessary. In practice, the "beauty contest" approach is confined to a short list of countries, all with economic fundamentals that satisfy the potential investor. At that point, it may seem that direct incentives would "help" the investor to make a final decision or, in other words, to reward a country's efforts in improving its business climate.

However, direct incentives can have adverse consequences that are not immediately obvious and these need to be taken into account when designing incentive policies. Tax rebates and subsidies, exclusively for foreign investors, are a form of discrimination against local business which, in Chile, is forbidden by the Constitution. In addition, both tax rebates and subsidies reduce the fiscal resources that would otherwise be available for investment in, for example, education or infrastructure. In this way, the cost of the incentives may cancel out the positive externalities of higher FDI.

However, a more important objection to direct subsidies is their detrimental effect on transparency. Direct incentives are not usually disclosed publicly since this would only encourage investors to take them as a baseline from which to start negotiations. Similarly, direct incentives give government officials discretionary powers. The problems of "picking winners" are well known and history is not short of stories about governments that have picked the wrong winner. In addition, lack of disclosure and discretionary decisions help to create an environment of secrecy that contravenes the basic principles of good governance.[6]

However, despite these problems, direct incentives can sometimes be appropriate. As Blomström (2001) notes, there are cases in which positive externalities in some sectors are so clear – i.e. the "picking winners" problem is not present – that direct incentives are justifiable.

In these cases, a good incentives policy should be based on:

- Non-discrimination between foreign and local investors. If incentives are used to develop a specific sector, they should be available independently of an investment's origin.

- Clear rules for selecting beneficiaries. These should also be as objective as possible.

- Full public disclosure. This should include the terms of the incentives and their amount.

- Mechanisms to maximize externalities. Rather than simply providing standard tax breaks, mechanisms should be designed to maximize positive externalities and allow the local community to share the benefits of the investment.

Because Chile gives priority to transparency, non-discrimination and market-friendly policies, direct incentives do not fit into its scheme of public policies. Instead, it has chosen the "beauty contest" approach and focused on improving its fundamentals in a bid to become more attractive to foreign investors. One advantage of this approach is that the improvements work to the advantage of local firms, as well as foreign investors, and thereby benefit the entire country.

However, Chile does make a limited use of direct incentives to boost the development of geographically isolated or particularly depressed areas and to encourage the development of new industries. These incentives do not discriminate between foreign and local investors and tax breaks are available automatically to all firms that fulfil the required criteria, while government grants, managed by CORFO, are awarded on the basis of clear rules that reflect a scheme's objectives.

It is true that the tax advantages offered under DL 600 are available only to foreign investors. However, as described in the previous section, these are not tax breaks, but rather a form of insurance against possible future changes in taxation. This type of protection was considered necessary, and proved useful, when Chile was in the process of building its international credibility and FDI to developing countries was less common.

Empirical Evidence

There is substantial empirical evidence that supports Chile's approach by demonstrating that sound fundamentals, rather than direct incentives, are the key to attracting FDI. In a recent study, Stein and Daude (2001) used a large sample of countries to study the determinants of FDI and found a positive correlation between direct incentives and FDI. However, they found an even stronger correlation between FDI and a country's fundamentals and, particularly, the quality of its institutions.

Stein and Daude also studied several variables that are generally believed to influence FDI. They found that some, such as education and infrastructure, have the expected impact, but lose significance when other variables, such as the quality of institutions, are included. The case of education is particularly interesting. Although it does not seem to be an important determinant of FDI levels, it appears to have a significant impact on the type of FDI that a country receives. Other authors have found that a higher level of education increases the benefits that a country derives from FDI.

Variables that measure the quality of institutions try to differentiate between countries that suffer from excessive regulation, corruption and political instability and those in which the law is respected, the government honours its commitments and the civil service is competent. The variables used are those developed by Kaufmann, Kraay and Zoido-Lobatón and include freedom of political expression, government accountability, political stability, government effectiveness and efficiency, the regulatory environment, respect for the law and the level of corruption.

The results show that institutions do matter a great deal and that a country's regulatory environment is the single most important variable, while freedom of expression and accountability are the least important. The results also indicate that moving to the OECD average level, up from the average for Latin America, implies increasing FDI by a factor of 2.8. Similar conclusions are reached by other studies. Wei (1997) for example, concludes that corruption, because of its unpredictability, weighs more heavily than the level of taxation.

FDI in Chile: key determinants

As suggested by Balasubramanyam (2001), a country's legal framework is an important determinant of its ability to attract FDI. There is no doubt that this has been a key factor in Chile where the legal framework, described above, has helped to ensure stable and predictable rules and procedures.

However, Chile's business climate has also been identified as another crucial advantage. In 2001, the Economist Intelligence Unit (EIU) ranked Chile as possessing Latin America's most favourable business climate, based on its "strong policy record, macroeconomic stability and fair growth prospects". On a global scale of the best places to do business in the next five years, the EIU put Chile in 21st place among 60 countries.

Many factors go to make up this propitious business climate. However, they can be grouped into five basic categories: Macroeconomic Environment, International Integration, Institutions and Governance, Social Cohesion and Infrastructure.

Macroeconomic environment

Between 1990 and 2000, Chile experienced annual average growth rate of 6.4%, ahead of other Latin American countries and among the fastest rates in the world. Even in the current recession, Chile has managed to grow by 2.9% in 2001, outpacing most of its emerging market peers.

Economic growth has been accompanied by decreasing inflation, a sharp drop in public debt, stable external accounts and strong international reserves. This achievement is the result of Chile's commitment to economic liberalization and free-market policies, as well as of its pledge to maintain sound and responsible economic management.

Chile's process of economic liberalization and deregulation began in the 1980s under a military government, but has taken even larger steps forward since the country's return to democracy in 1990. The first reforms included the opening of the country to foreign trade and investment, the privatization of public companies, a reduction in the size of the public sector, the introduction of a pioneering social security scheme based on private pension funds, and the implementation of prudential banking regulation. In addition, the creation of an autonomous Central Bank in 1989 was a key factor in reducing inflation from 27% in 1990 to within the Central Bank's present medium-term target range of 2%-4%.

In recent years, a number of additional measures have been taken to reduce market inefficiencies and encourage competition, as well as to strengthen the institutions that guarantee Chile's stable macroeconomic fundamentals:

- In 2000, the government introduced a new fiscal policy which aims to maintain a structural budget surplus equivalent to 1% of GDP. This policy has the advantage of ensuring medium-term fiscal restraint, while permitting counter-cyclical measures in periods of slower economic growth.

- In 1999, Chile adopted a floating exchange rate and has now eliminated most capital controls. This reflects the authorities' commitment to the market as the mechanism for determining key prices in the economy.

- A far-reaching deregulation of capital markets, implemented in December 2001, aims to increase the liquidity of domestic markets, encourage savings and improve the access of new projects to investment finance. During 2002, the government plans to announce a second package of measures, including incentives for the development of a local venture capital industry.

Chile's sound macroeconomic fundamentals have been recognized by many international institutions. The *2001 Global Competitiveness Report* of the World Economic Forum (WEF) ranked Chile as the most competitive country in Latin America and in 27th place among 75 countries. In the report's Macroeconomic Environment Index, Chile is ranked in 21st place, in a better position than Austria, Sweden and Denmark.

International credit rating agencies not only award Chile a privileged place within Latin America, but also put it in a very favourable position as compared with other emerging markets. During 2001, Chile's country risk held steady at an average of 179 basis points over US Treasury bonds, while other Latin American and emerging market sovereign bonds traded at an average spread of 882 and 837, respectively. In late December, when Argentina's country risk hit a record of 5,500, Chile's spread was running at only 157 points.

International Integration

International integration favours FDI not only because it increases the market to which a country has access, but also because investors view it as a seal of good behaviour. In order to achieve international integration, a country needs to fulfil certain conditions, such as macroeconomic stability. These, in themselves, make a country more attractive for FDI,[7] but the risk of failing to reach an international agreement is also a strong deterrent against a departure from good behaviour.

Most studies attest to the importance of market size as a key determinant to FDI. Because Chile has a domestic market of only 15 million inhabitants and its per capita income is still under US$5,000, integration into global markets is vital. Chile has adopted a policy of market enlargement by establishing an extensive network of trade agreements that include FTAs with Canada and Mexico, an association agreement with the MERCOSUR block, bilateral treaties with Venezuela, Colombia, Ecuador and Peru and an agreement with the Central American countries, as well as membership of the APEC forum.

By early 2002, negotiations on FTAs with the United States, the European Union and the EFTA countries had made substantial progress and Chile was also holding exploratory trade talks with South Korea and New Zealand. In addition, Chile actively supports efforts to establish a Free Trade Area of the Americas (FTAA).

For imports from countries with which it does not have a trade agreement, Chile applies a flat tariff which is scheduled to drop to 6% in 2003 as part of a five-year program on one percentage unilateral annual reductions. This program, along with Chile's FTAs and its low level of non-tariff barriers, make it one of the world's most open economies.

Answering a common concern among FDI investors, Chile has been active in negotiating double-taxation agreements. As of March 2002, it had signed agreements with Argentina, Canada, Mexico, Ecuador, Peru, Brazil, Poland and Norway, of which the first three were already in force. In addition, negotiations were underway with South Korea, Malaysia, Germany, Spain, Finland, France, the United Kingdom, Sweden and New Zealand.

International integration has helped Chile to diversify its exports. More than 5,600 companies now export almost 4,000 different products to 176 countries. As a result, copper represents only 39.8% of returns, down from 46.1% in 1990. Chile's exports are also geographically diversified between Asia (31% of total returns), Europe (27%), Latin America (22%), and Canada and the United States (18%).

Institutions and Governance

According to Transparency International (2001), Chile is one of the most transparent countries in the world. In its *Corruption Perceptions Index 2001*, the organization ranked Chile in 18th place out of 91 countries, putting it on a par with Ireland, Germany and the United States.

Similarly, in a study of transparency in 35 countries, published by PriceWaterhouseCoopers in 2001, Chile and the USA tied in second place after Singapore. The study looked not only at corruption as such, but also at a country's legal and judicial system, its regulatory environment, economic policies, accounting standards and corporate governance.

Chile achieved its highest scores on legal and regulatory environment, accounting standards and macroeconomic policy. According to PriceWaterhouseCoopers, Chile's low level of "opacity" – as it calls lack of transparency – has an impact on FDI flows equivalent to imposing a 5% tax on investment returns, while the average figure for the sample was 24.2%.

The WEF also recognizes Chile's achievements in this area, by placing the country in 21st place in the world in the Public Institutions Index and in 13th place in the Corruption Sub-index.

Strong institutions have been a feature of Chile's history, helping to provide predictability. However, through its commitment to modernization, the government is also striving to ensure their ongoing efficiency and fairness.

This modernization program includes a major overhaul of the country's judicial system. The reform, which is being implemented gradually as from 2001, seeks to improve access to justice and reduce trial times. Similarly, a new law regulating tender share offers has improved protection for minority shareholders' rights and set higher standards of corporate governance. According to Santander Investment (2001), Chile's minority shareholders now enjoy better protection than in any other Latin American country.

Social Cohesion

In empirical studies, social issues are not typically included as a determinant of FDI. However, in our experience, they increasingly concern foreign investors, both as issues in their own right and from the point of view of political and institutional stability.

Chile's high economic growth has gone a long way to improve social conditions and reduce poverty. In addition, since the return of democracy in 1990, active social investment policies have been implemented. In 1990, 39% of Chileans lived below the poverty line, but by 2000, this had dropped to 21%.

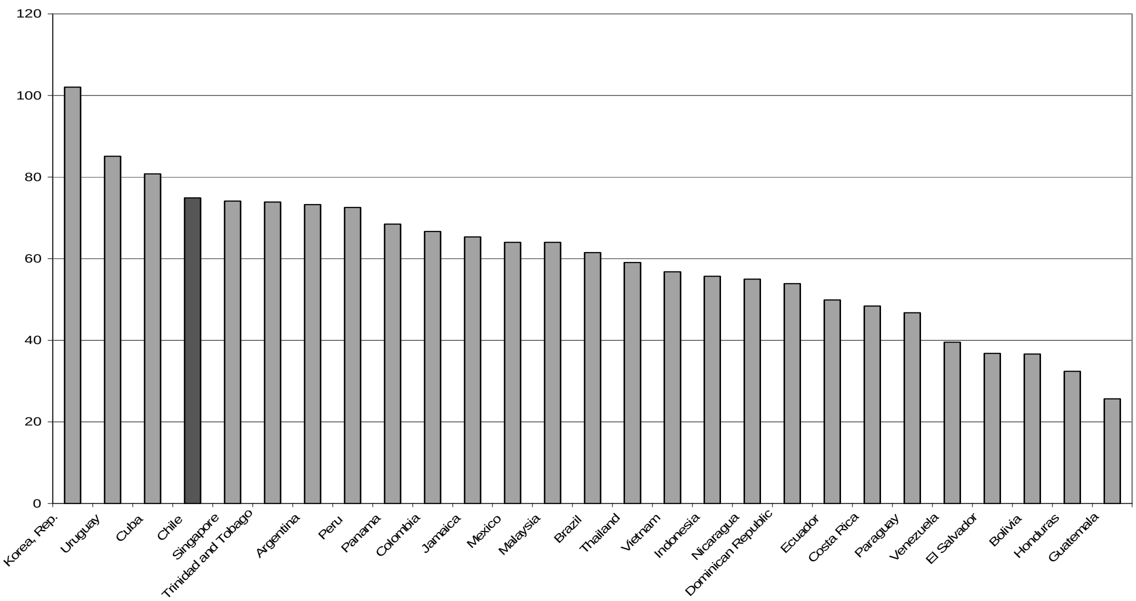
According to the United Nations Development Program (UNDP), Chile has Latin America's third highest level of human development. However, the government aims to make further progress in this direction, reducing income inequality and attempting to ensure that all Chileans have access to the benefits of economic growth.

The most direct impact of social investment on FDI is through improvements in educational standards and labour productivity. This is commonly measured as the rate of enrolment in secondary education and Figure 5 sets out gross enrolment ratios[8] for Latin American and South East Asian countries. Chile occupies third place in Latin America, after Uruguay and Cuba, and is fourth in the overall sample.

The coverage of primary and secondary education in Chile reaches 99% and 90%, respectively, and 27% of students go on to higher education. Similarly, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), average schooling is 10.4 years, the highest in Latin America.

Nonetheless, in 1995, the government launched a major educational reform in a bid to improve the quality of schooling and to lengthen the school day. By 2000, public spending on education had reached 4.2% of GDP, up from 2.5% in 1990. Combined with private spending, this brought total expenditure on education up to 7% of GDP.

Figure 5
Gross Enrolment Ratio in Secondary Education



In a further attempt to improve social welfare, the government is setting up an unemployment insurance scheme, which is due to start operations in mid-2002. Like Chile's private pension system, the scheme is based on individual savings account, to which both a worker and the employer will contribute. These accounts will be managed by a private administrator and have the additional advantage of helping to increase the liquidity of Chile's capital markets.

Infrastructure

According to the EIU's Worldwide Business Cost Comparison for 2001, Chile is the 6th least expensive place in which to do business, out of a sample of 31 countries. That is partly because of Chile's relatively low taxes and labour costs. However, the report also highlights infrastructure, particularly with regards to telecommunications, transport and office-space costs, as a factor in Chile's favour.

Chile began to privatize its utilities and infrastructure in 1980s, setting a lead that other Latin American countries subsequently followed. As well as gains in service standards, privatization and deregulation have meant lower charges, mostly as a result of increased competition. In the energy sector, for example, private investment has given Chile one of the region's lowest levels of service interruption, while international telephone calls from Chile are identified as the cheapest in Latin America.

Fixed telephone density increased to 22% in 2000, up from 6.7% in 1987, and has since been surpassed by the penetration of mobile telephony. Similarly, the construction of new fibre optic cable links has improved the quality of Chile's communications with the rest of the world.

The government is actively promoting access to Internet in a bid to avoid a "digital gap" within the country. Commuted Internet connections grew by 23.4% in the second half of 2000, while dedicated connections increased by 223.3%. Independent estimates suggest that, in 2000, the number of Internet users rose by almost 30% to 1.8 million.

The government's infrastructure concessions program, launched in 1993, initially focused on roads and airports, in which it has meant substantial improvements. The scheme is now being expanded to include public-private partnerships for the construction and operation of new prisons, irrigation reservoirs, urban development projects and recreational facilities.

Present and future challenges

Chile's attractive business environment is the result of a policy-driven strategy that has focused on building sound macroeconomic fundamentals and strong institutions, promoting competition and international integration and creating a fairer society in which all citizens enjoy the benefits of economic development. In turn, this business environment has been a key determinant of Chile's success in attracting foreign investment.

However, changes both in Chile and in the international economy have created new and complex challenges. In this context, it would be wrong to assume that a policy, which has worked in the past, will continue to do so in the future.

Most of Chile's productive activities and public services are now privately owned. As a result, future FDI in these sectors will be confined largely to M&As, which depend on global markets and the strategic goals of international corporations, rather than exclusively on the business environment of a particular country. Similarly, most of Chile's known mineral deposits are already being developed and, at current prices, foreign firms are less prepared to invest in new exploration projects. In addition – and more importantly – other countries have joined the race to capture FDI flows. And many of them offer generous tax incentives in a bid to lure multinationals.

The second phase of Chile's infrastructure concessions program and the recent deregulation of its capital and financial markets have created new investment opportunities. However, we now need to attract FDI in other new areas, particularly the services and technology industries.

The expansion of these industries would allow Chile to add value to its abundant natural resources and to take greater advantage of the export opportunities created by the country's increasing international integration. In addition, the services and technology sectors tend to have a significant impact on the job market, creating new and high-quality employment opportunities.

One of the main challenges that Chile now faces is to increase the competitiveness of its technology sector, which lags well behind the competitiveness of most other sectors of the economy. In its *2001 Global Competitiveness Report*, the WEF ranked Chile in 27th place on overall competitiveness, but only in 42nd place for the technology industry. According to the WEF, Chile's level of technological development is "normal" for its income level, but we are aware that this leaves a great deal of room for improvement.

The World Economic Forum and Harvard University recently released their *Networked Readiness Index* (NRI),[9] an assessment of countries' capacity to exploit new information and communication technologies (ICTs). It ranked Chile 34th in the world and second in Latin America, giving it high scores on ICT policies, telecommunications infrastructure and e-government. However, the country scored poorly in other areas, including its readiness to make new technologies accessible to a majority of the population.

According to the WEF, the transition from a middle-income to a high-income country means evolving from a technology-importing economy into a technology-generating one. This requires changes in government priorities and spending patterns, as well as the design and implementation of public policies that foster innovation through investment in R&D and education. Capital markets and regulatory systems also need to be adapted to facilitate the start-up of high-technology enterprises.

This is one of the challenges now facing Chile, even though it is a leader in connectivity in Latin America – it currently enjoys South America's highest computer and Internet penetration rates – and its progress on e-government is recognized internationally. Rising to the challenge, President Ricardo Lagos has proposed a series of measures to further increase connectivity, encourage the growth of e-commerce and e-learning and to promote the development of a venture capital industry, as well as continuing to advance in the use of e-government.

As part of this policy, the government is making a specific effort to encourage investment in high-technology industries. After analyzing Chile's competitive advantages – principally its infrastructure, the availability of skilled labour and its low operating costs – the government identified service industries, such as call and contact centres and back office operations, and software development as its main targets.

This focus inevitably raises the issue of tax incentives. In a recent interview,[10] Jeffrey Sachs, Director of the Center for International Development at Harvard University, said he was *"convinced that tax incentives are a good way to attract technological companies to a country and I do not think that Chile has explored that path appropriately"*. This is a particularly sensitive point in Chile. Several years ago, Intel's decision to install a computer-chip plant in Costa Rica, rather than Chile, generated a heated debate as to whether Chile should have offered tax incentives.

We are aware that incentives can tilt an investment decision, especially if a firm has to choose between two otherwise very similar locations. As suggested by Blomström *op cit*, this is particularly true if the incentives offered reduce the initial investment outlay. This is the reason behind the Chilean government's recent decision to offer the package of financial incentives, described at the end of Section II. These incentives, in fact, proved to be a key factor in a multinational company's recent decision to base its regional Latin American call-centre in Santiago, rather than in other possible locations with similar fundamentals, infrastructure and operational costs.

However, we don't see this strategy as a departure from the principles that have guided our FDI policy until now. The incentives are available equally to foreign and local investors and are, therefore, in line with Chile's commitment to non-discrimination. In addition, they do not seek solely to attract FDI, but are part of a broadly-based development plan, designed to promote activities with large potential externalities and spin-off effects in areas such as job creation, technology transfer, R&D, education and training.

Extrapolating from the case of Singapore, cited by Bergsman (2000), these incentives seek not so much to increase FDI flows as to attract specific projects that will influence the structure – not the total amount – of economic activity. However, this goal cannot be achieved only through incentives. As Blomström points out, "in addition to investment incentives, governments should also consider their efforts to modernise infrastructure, raise the level of education and labour skills, and improve the overall business climate as parts of their investment promotion policy".

That is precisely what Chile's main policy measures seek to achieve:

Technological innovation: In a bid to encourage technological innovation, the government is setting up public Internet access centres around the country and providing soft loans to help teachers and small firms to acquire PCs. Government training programs not only include Internet and computer courses, but are also beginning to use distance learning systems. In addition, Congress has passed a law authorizing the use of electronic signatures and is currently debating a bill that would bring Chile's legislation on intellectual property rights into line with international standards.

Modernisation of the State: An Inter-American Development Bank report (2001) revealed that setting up a new business in Chile involves 12 different legal steps, as compared to an average of three in developed countries. The government is making a special effort to harness new technologies to help reduce bureaucracy, increase the transparency of its operations and improve the public's access to information. In addition, as part of its bid to eliminate red tape, it will seek Congressional approval for a bill on administrative silence that would assume that a permit or other type of application has been granted, if a government office fails to process it within a stipulated time limit.

International integration: The government aims to continue strengthening Chile's international integration by negotiating additional free trade treaties and double-taxation agreements. Rapid progress is being made in this area and will further expand Chile's export markets, thereby creating new business opportunities.

Upgrading infrastructure: The second phase of Chile's infrastructure concessions program, launched in 2001, comprises projects worth US$5 billion. Like the first phase, it includes roads and airports, but has also been expanded to new areas, such as prisons, irrigation projects, recreation centres and real estate projects.

Finance for new companies: A second phase of the reform of Chile's capital markets reform, due to be announced in mid-2002, will include measures to improve start-up companies' access to finance and encourage the development of a venture capital industry.

Improving competitiveness at a micro level: Now that Chile has largely completed its privatization program and its markets have been deregulated, attention is turning to microeconomic measures that would eliminate distortions and increase competition. The measures that the government is preparing include an update of electricity industry regulation and improvements in consumer protection as well as new regulation for the fishing industry and changes to bankruptcy legislation.

Strengthening democracy: After a decade of stable democracy, the government plans to seek Congressional approval for a number of measures that would increase the representativeness of the country's political system. These include the elimination of non-elected senatorial posts and the introduction of a higher degree of proportional representation in the electoral system.

Most importantly, however, the government plans to continue its **policy of active social investment.** This includes a major overhaul of Chile's health system, of which the first stage was announced in early 2002. Partly by ironing out inefficiencies in the present system, the reform aims to provide greater equality of access to healthcare. However, the underlying goal of this reform, as of the ongoing educational reform, is not only to improve productivity and increase Chile's competitiveness but – primarily – to ensure that Chileans with relatively low income enjoy the benefits of economic growth.

We are convinced that these programs and policies will not only mean sustained growth, but also improve the quality of life of all Chile's citizens. In an added spin-off, we also anticipate that they will enhance Chile's ability to compete in the "beauty contest" for FDI.

NOTES

1. Daisy Kohan, Rodrigo Cifuentes and Francisco Javier Díaz collaborated with research for this paper. Special thanks to Ruth Bradley for her invaluable comments.

2. Figures in this section use the latest data available in World Development Indicators, World Bank, 2001. In this database, countries are classified as having low, medium or high-income levels.

3. Or equivalently, they grew at an average rate of 18% per year.

4. This section refers to investment that entered Chile via DL 600, which is the main channel for FDI.

5. This will increase to 16.5% in 2003 and 17% in 2004 in order to compensate for revenue losses resulting from a reduction in personal income taxes, approved by Congress in 2001.

6. Oman (2000) and Blomström (2001) argue in this direction.

7. Blomström *op cit*.

8. Gross enrolment ratio is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to a given level of education. Net enrolment considers only students of the official school age. Data on the latter definition is too scant for a relevant comparison.

9. World Economic Forum (2002).

10. *El Mercurio*, 2nd February, 2002.

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THE SHIFTING PARADIGM OF FDI POLICY AND PROMOTION IN THAILAND

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Introduction

It is axiomatic that as a country moves up the developmental ladder, it will continuously need to adjust its national priorities, if it wishes to advance to the next level. Clearly this has been the case in Thailand, and this treatment of investment policy and promotion as a living, breathing entity, rather than a "carved-in-stone" monolith, has been extremely successful.

Indeed, since 1985, the Thailand Board of Investment (BOI) has approved 8,500 projects, with total investments of more than 1.5 trillion baht (US$35 billion), and creation of some 2.1 million jobs for Thai workers. In addition, this has led to substantial improvements in the quality of Thai-manufactured goods, particularly in the automotive, electronic and fashion industries, and as a result Thai-manufactured products in these industries have gained a foothold in the toughest of international markets.

Institutional set-up

As I go through the changes to investment policy, you will be able to observe that these revisions to Thai investment schemes corresponded closely with changes in the nation's overall macroeconomic situation and have responded to national development objectives.

While the Board of Investment is the agency responsible for attracting FDI, there are other government agencies that play a role in creating an investment environment that is appropriate for the country at a given point in time. So, while the focus of this talk will be on investment promotion, not all of the actions described represent policies of the Board of Investment, but rather that of the government as a whole.

Although investment promotion in Thailand dates back to more than three decades, the BOI is officially governed by the 1977 Investment Promotion Act, as amended in 1991 and again in 2002. The Act prescribed that the Board would be chaired by the Prime Minister, with economic ministers, senior civil servants, representatives of major private sector organizations, and academics serving as Board Members or Advisors.

At the time that the Investment Promotion Act came into existence, it is important to understand that there was very little industry in the country, and what there was, consisted mostly of assembly operations. The domestic marketplace was relatively small, and the average Thai consumer had very little disposable income.

Capital goods, therefore, had to be imported, as were many raw materials and components, with the obvious exceptions of agriculture and minerals, the result being foreign exchange shortages and balance of trade deficits.

In response, the Thai government recognized the need to develop indigenous industries that would minimize the reliance on costly imports, and hence foreign exchange and balance of trade shortages, and early investment promotion policy reflected this import substitution focus.

High levels of protection were afforded to indigenous industries, particularly in the form of import tariffs, which were set at rather high levels, in order to “force” a market for Thai-manufactured goods.

One example of how this worked, in practice, is the automotive industry, which came into existence during the late 1960s and early 1970s, with several joint-ventures assembling vehicles from completely-knocked-down (CKD) kits. During the mid 1970s, investments in auto parts and components began to come into Thailand, but the domestic market was not sufficient to provide the necessary economies of scale that would make these local manufacturers cost-competitive.

It soon became apparent that if the government did nothing to protect local assemblers, a market for Thai-manufactured vehicles would not develop, as the existing tariff structure did not adequately protect assemblers from completely built up (CBU) imports, nor would the local parts and component manufacturers be able to develop.

Accordingly, starting in 1978, the government instituted a ban on CBU imports, increased the tariff on completely knocked down (CKD) kits, and through the 1980s, the government protected local parts manufacturers, by increasing the local-content requirements to more than 50%.

By the mid- to late 1980s, the policies that were designed to nurture fledgling industries in Thailand began to show results. Indeed, Thailand’s ability to provide cost-effective local inputs (raw materials, labour and infrastructure) started to attract large numbers of industrial projects, including the first wave of Japanese investors, who were disadvantaged by the appreciating Yen and resultant increases in labour costs.

Companies that came to Thailand during that period prospered, and word rapidly spread that Thailand was, in many ways, an ideal offshore production site, possessing large pools of affordable and trainable labour, abundant natural resources, government protection for fledgling industries, and policies that allowed businessmen, for the most part, to operate as they deemed appropriate.

This inflow of foreign industrial projects continued into the early 90s, attracted by explosive growth (Thailand averaged 8.4% GNP per capita growth between 1985-1994) and a high degree of economic freedom. Soon problems began to emerge.

Regional distribution of FDI

Bangkok and surrounding provinces had attracted the lion’s share of the foreign investment, and this led to increased pollution and congestion, as well as shortages of skilled labour, as infrastructure development could not keep pace with the demands placed upon it by the extremely rapid growth. In addition, the flood of business activity in the greater Bangkok area led to even greater inequality in economic opportunities between Bangkok and the provinces.

To address the issue of unequal distribution of wealth and prosperity, the government's 6th and 7th National Plans, developed by the National Economic and Social Development Board, focused on narrowing the gap in economic activity between Bangkok and the provinces.

In support of these plans, and to address some of the problems created by the rapid development of Bangkok, the Board of Investment enacted new measures designed to promote industrial decentralization by dividing the country into three zones, based on location.

Simply put, projects that located in Zone 2, the provinces surrounding Bangkok, received larger incentives than projects locating in Bangkok and surrounding provinces, while the greatest amounts of incentives were reserved for provinces that located in Zone 3, areas 150 km or more from Bangkok. To further promote decentralization of industry in 1993, the BOI removed the requirement that foreign-owned companies in Zone 3 export at least 80% of their products.

These policies proved quite successful in terms of attracting investment upcountry, but it should be noted that the policies were less successful in impacting each province equally; rather it established industrial hubs close to the boundaries of each zone.

Investment promotion and enabling environment

Investment promotion policy remained relatively unchanged until 1997, with minor adjustments made to increasingly liberalize the program or open new categories.

In 1997, Thailand fell victim to the financial crisis that ultimately plagued much of the region. As a result, the government reacted swiftly to restore investor confidence. In addition to implementing measures mandated by the International Monetary Fund, Thailand began an impressive series of reforms to outdated economic laws. Indeed, by early 1999, more than 100 new laws or revisions had been implemented.

By strengthening the country's legal and regulatory framework, Thailand improved the overall economic climate, one key element of the investment environment. One of the objectives of the government at that time was to increase Thai-manufactured exports, as a means to generate much-needed foreign currency earnings, and enable the country to build international reserves and strengthen the baht.

Accordingly, in 1997 and 1998, the BOI adopted a number of short-term measures that facilitated increased export of Thai-manufactured goods and save foreign currency through promotion of import substitution. For example, we let existing projects operate at full capacity in order to permit them to achieve economies of scale and to find new markets; we relaxed zoning requirements for export-oriented projects; we provided import duty waivers for new machinery in 61 categories of export-oriented industries; and we offered exemption of import tax on raw materials to non-BOI promoted companies, thereby helping them become more competitive in the global market place. In addition, the import duty guarantee requirements were reduced for the 500 top exporters from 50 to 5 per cent of the import duties payable on inputs imported for processing export products.

Were these measures successful? Well, after declining by 6.6 per cent in 1998, exports grew from US$54.5 billion to US$69.9 billion from 1999 to 2001. And while there were many factors which supported export growth, it is fair to say that the measures adopted by the BOI, at least contributed to this revitalized growth in exports.

During that time, it also became increasingly clear that viable joint ventures were experiencing financial difficulties arising from the impact of the financial crisis. To solve this problem, the BOI permitted foreign partners to own a majority or all shares in manufacturing projects. By so doing, we enabled foreign partners to inject much needed capital into joint ventures. However, the liquidity crunch limited their local partner's ability to invest in proportion to the previous shareholding requirements.

The BOI also took steps to improve the overall investment environment by implementing measures to facilitate investment and improve industrial competitiveness. We established a One-Stop Service Centre for Visas and Work Permits to process work permits and long-term visas in three hours or less, and we granted promoted companies permission to own land for residential and business purposes. In addition, to improve industrial competitiveness, the BOI promoted new activities, such as logistics and international procurement offices, and required new projects to obtain international certification, such as ISO 9000, within two years of start-up.

This brings us to the present day. In 2001, Thailand elected a new Prime Minister, Thaksin Shinawatra, and he had plans to restructure the Thai economy, and he has implemented a "dual-track plus" policy that embraces not only export-generated growth, but domestic-led growth and poverty eradication as well. His vision includes attracting investment that draws talent and promotes R&D and skills development, as well as technological development and transfer of technology, for he fully understands that in the 21st century, productivity-driven wealth creation is more desirable than capital-driven wealth creation. He also believes that the government should encourage the development of clusters, as they will enable businesses to take advantages of economies of scale and efficiency throughout the supply chain, and will foster increased amounts of R&D as well.

To accomplish these objectives, the BOI has adopted seven key strategies.

First and foremost, with the impending implementation of AFTA, WTO stipulations, and the further reduction of tariffs on machinery and raw materials, it is undeniable that the importance of tax-based incentives is rapidly diminishing. Therefore, if Thailand is to remain an attractive site for foreign investment, the BOI must remove impediments and create an **enabling environment for investors**. To learn what investors consider to be the most pressing issues, the BOI is consulting with foreign investors, both at home and abroad. Issues not already addressed by a joint public-private sector committee headed by the Prime Minister were then taken up by the BOI.

In addition, to sorting out investor problems, the BOI has reorganized internally and has set up an investment facilitation unit, tasked with working with investors in areas such as domestic sourcing and subcontracting, human resources development, and coordination with other government agencies. We have also removed location requirements for projects in all but a handful of environmentally-sensitive activities, thereby giving investors almost total control of their projects.

If tax incentives are a priority, investors can locate in our least developed provinces and take advantage of maximum incentives. If, on the other hand, an investor's business model deems it most important to be located close to suppliers or end users, and that location is in Zone 1, he/she is now free to do so. We believe that by lifting this restriction, we have both removed a barrier to investment, and have paved the way for cluster development.

A **second** strategy involves **proactive targeting of investors**, both by sector and by region, in order to improve both the quality and quantity of investment, which will help develop and enhance sustainable growth of the Thai economy.

Accordingly, three major regions have been targeted as the focus for advertising, marketing and promotional efforts. Europe, Asia (especially Japan), and North America will be beneficiaries of this new focus. These regions will see more missions, as well as more visits from the BOI's mobile units.

In addition, more overseas offices will be opened in these regions to ensure that they provide individualized service to investors in these countries, and within the next 12 months, we expect to open new offices in Shanghai, San Francisco and Osaka that will be staffed by some of our best people, fluent in the language of the country.

From a sectoral perspective, the BOI has identified five industries that will be aggressively targeted: Agro-industry; Automotive; Fashion; ICT including Electronics; and High value-added services. Having identified the industries, the next step is to develop policies, measures, and marketing strategies specific to each industry, taking into consideration their needs, based on factors such as competitiveness, market potential and levels of technology. We believe this kind of government support for key industries will almost certainly lead to cluster development, and all the benefits, described earlier, that come with it.

Our **third** strategy is to improve the way we market Thailand, by **improving our networking** in target regions. To accomplish this, we are actively seeking cooperative agreements with public and private sector organizations, including other investment agencies, banks, and provincial governments. Earlier this year, for example, we signed joint marketing pacts with the four largest banks in Japan, as well as a major European bank, and we have also signed joint promotion agreements with several investment promotion agencies in the region. The advantages of this kind of collaboration is clear; by working together, we can improve the bilateral flows of information for the investment community, and this will help us meet investor needs.

The **fourth** BOI strategy involves upgrading Thai competitiveness at the SME level. To help SMEs become more productive, we will expose Thai SMEs to “industry-best” practices and technologies and the importance of skills training and technology transfer. In addition, we will work with foreign investors to attract technologies new to Thailand and introduce them to Thai SMEs. Another of our strategies is to transform our regional offices into marketing organizations to help improve the capabilities of Thai SMEs at the grass-roots level.

The object of the **fifth** strategy is to choose the most promising enterprises for marketing, and then encourage foreign SMEs to participate in these “**community enterprises**,” by providing technical assistance and advising on how best to reach overseas markets. By focusing on selected quality projects and trying to improve them, the BOI is trying to create success stories that can then be replicated in other villages around the country.

Our **sixth** strategy involves tracking changes in the international investment marketplace to determine the appropriateness of BOI policies. The BOI will, therefore, **monitor investment regimes** from around the world, in order to help the BOI **identify investment trends**. In so doing, the BOI will be able to provide both investors and the government with early warnings about the impact of legislative and procedural changes resulting from international agreements.

The **seventh**, and final, strategy is to improve the way the BOI does business. While we have already earned ISO 9002 certification, thereby ensuring fair treatment for all investors, the BOI will be working to improve the level of service we offer investors. More importantly, we will be looking to find ways and means to speed up processing times by **streamlining procedures and cutting through unnecessary “red-tape.”**

From the experiences I have shared with you this morning, I think you will appreciate that Thailand’s Board of Investment has worked closely with other government agencies to develop an investment framework that is, on the one hand, among the most liberal and attractive in Asia, and on the other hand meets changing developmental objectives of the central government.

FOREIGN DIRECT INVESTMENT IN ASIA
HOW TO MAXIMISE ITS BENEFITS?

Rajan R. Gandhi, Director India, Consumer Unity and Trust Society (CUTS)

Overview

Ongoing research by CUTS confirms the lack of evenness in FDI inflows into Asia with South East Asia (including China) receiving the bulk of inflows and registering the highest growth rates. In contrast, countries in West and Central Asia have received little interest and South Asia, too, would not have figured had it not been for India.

The impact of FDI on emerging Asian economies has been varied. In certain countries, FDI has crowded out domestic investment and only 22 out of 107 countries in one survey could show a positive effect on domestic investment. The impact on job creation is also similarly mixed. Perceptions of the value of FDI are mixed.

Reactions to the incentives for attracting FDI inflows are varied. There seems no consistency in the appeal of different measures and an intangible feeling of being "welcomed" by a host country seems to be more important than conventional wisdom would dictate.

It is considered vital for each country to determine its own national priorities and channel FDI in the manner best suited to achievement of these priorities.

Introduction

Global foreign direct investment (FDI) flows have grown at an average annual rate of 20 per cent over 1991-95 and at 32 per cent during 1996-99. Flows increased from US$159 billion in 1991 to US$865 billion in 1999, a massive jump of 444 per cent. Most FDI flows however take place between developed countries. The share of developing countries rose sharply during the early 1990s from 26 per cent in 1991 to about 40 per cent in 1994 but it declined to about 24 per cent in 1999.

Even within the group of developing countries only a few large developing countries (e.g. China, Brazil) have been receiving most of the FDI. Though many developing countries have taken measures to attract higher FDI, most of them have been largely unsuccessful in this regard.

Asian developing countries or emerging Asia have received more than half of all FDI inflows to developing countries. In 1993 their share in global FDI shot up to 70 per cent but subsequently with Latin American countries increasing their share in the global FDI, emerging Asia's share reduced.[1]

This paper briefly looks at FDI trends in Emerging Asia, compares FDI with other forms of capital flows and investigates the expected impact of and hindrances to FDI. It also looks at civil society perceptions of FDI and measures to maximise benefits from FDI.

The latest trends in Asia

FDI flows in 1990s into Emerging Asia varied greatly from region to region. Inflows into developing Asia reached a record level of US$143 billion in 2000, which was a 44 per cent increase over 1999.[2] Primarily an unprecedented FDI boom in Hong Kong, China drove Asian FDI flows in 2000. Hong Kong, China received a record inflow of US$62 billion[3] and Mainland China received FDI flows of about US$41 billion in this year.

In 2001, Mainland China regained its position as the largest FDI recipient pushing Hong Kong, China into the second spot. India (in South Asia), Kazakhstan (Central Asia), Singapore (South-East Asia) and Turkey (West Asia) were leading FDI recipients in their respective sub regions in 2001.

Table 1: FDI Inflows by Host Region in Asia (millions of dollars)

	Region	Annual Average of 1990-95	1996	1997	1998	1999	2000	2001
1	Asia	47,321	93,331	105,828	96,109	102,779	133,707	102,066
2	West Asia	2,096	2,898	5,645	6,705	324	688	4,133
3	Central Asia	662	2,590	3,844	3,152	2,466	1,895	3,569
4	South, East and South-East Asia	44,564	87,843	96,338	86,252	99,990	131,123	94,365
Percentage of FDI Flows Received by Different Regions								
5	Asia	100.00	100.00	100.00	100.00	100.00	100.00	100.00
6	West Asia	4.43	3.11	5.33	6.98	0.32	0.51	4.05
7	Central Asia	1.40	2.78	3.63	3.28	2.40	1.42	3.50
8	South, East and South-East Asia	94.17	94.12	91.03	89.74	97.29	98.07	92.45

Source: World Investment Report 2002

Table 1 shows that the region South, East and South East Asia has received the highest FDI inflows between 1990-2001 (above 90 per cent). Within this region, South Asia received the lowest FDI in this period (see table 2). In 2001, the region received FDI inflows of about US$4 billion, which was a 32 per cent increase over 2000, of which US$3.4 billion went to India, a 47 per cent increase over the previous year. FDI flows into both Central and West Asia have increased from 1990-1995 to 2001 but with wide fluctuations. FDI inflows into Asia as a whole increased by 2.15 times in 2001 over 1990-95.

Table 2: **FDI Inflows in the sub-regions of South, East and South East Asia** (millions of dollars)

	Region	Annual Average of 1990-95	1996	1997	1998	1999	2000	2001
1	South Asia including Afghanistan	1,221	3,620	4,936	3,560	3,099	3,095	4,071
2	China	19,630	40,180	44,237	43,751	40,319	40,772	46,846
3	East and South-East Asia Excluding China	23,713	44,043	47,165	38,941	56,572	87,256	43,448
4	Total	44,564	87,843	96,338	86,252	99,990	13,1123	94,365
Percentage FDI Inflows in the sub-regions of South, East and South East Asia								
5	South Asia Including Afghanistan	2.74	4.12	5.12	4.13	3.10	2.36	4.31
6	China	44.05	45.74	45.92	50.72	40.32	31.09	49.64
7	East and South-East Asia excluding China	53.21	50.14	48.96	45.15	56.58	66.55	46.04
8	South, East and South East Asia	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: World Investment Report 2002

Asia's potential in attracting FDI

The World Investment Report 2002 reports that the prospect for Asia to attract high FDI is very bright over the next two-three years. It is important to note that apart from East and South East Asia, other regions do not receive FDI commensurate with their potential. The potential of a country could be measured by comparing it with economies with similar economic structure. It could be also be done by comparing the interest of investors in the country and the actual flow of FDI.

South Asia receives FDI much below its potential even though it has a large market. West Asia received less than 0.6 per cent of world FDI flows in 2001, which is about one-tenth of its share in the world GDP.[4] The distribution of FDI in this region is uneven, Turkey receiving the highest FDI. Countries of the region are capable of attracting FDI in export-oriented units producing low to medium technology goods and market-seeking FDI. Central Asia has the potential of attracting greater FDI in resource based activities, e.g. copper and zinc, and oil and gas extraction.[5]

A survey conducted by Multilateral Investment Guarantee Agency (MIGA) on 147 multinational companies found that among the leading investment destinations of these companies China figures in the second place with the USA in the first place. The other emerging Asian countries, which figure in the list of 23 countries, are Singapore (13th), Thailand (17th), India (18th) and Malaysia (22nd).[6]

How do we measure the impact of FDI on the economy?

The impact of FDI is examined by using different parameters such as capital formation, backward linkages, employment, technology transfer, market access and knowledge spill-overs.

Often the impact of FDI is ambiguous. Consider the issue of FDI and capital formation. FDI often crowds out domestic investment i.e. displaces or reduces it. FDI might also stimulate domestic investment by creating an investment environment favourable to it and, transferring technologies and management techniques. The relationship between FDI and domestic investment depends on, among other things, the quality of FDI, domestic regulatory environment and the time horizon studied. In the long run, if there are sequential investments to the initial one, FDI tends to have a favourable impact on domestic investment by stimulating it. The total effect is a sum of the component effects and quite difficult to predict. The empirical evidence on this is mixed (see Box).

Impact of FDI on Domestic Investment

A study carried out by Research and Information System for the non-aligned and other developing countries (RIS), India found that evidence of the effect of FDI on domestic investments is mixed. The study was conducted taking a sample of 98 countries covering the 1980-98 period. The results for Asian countries is summarised below:

1. In India, Fiji, Papua New Guinea, Philippines and Singapore FDI crowded out domestic investment.

2. In Pakistan, China, Indonesia, Malaysia and Turkey FDI flow has not had any effect on domestic investment.

3. In Bangladesh, Korea, Nepal, Sri Lanka and Thailand, FDI has had a positive effect on FDI by crowding in domestic investment.

4. Of the 107 countries surveyed, FDI has had a positive effect on domestic investment in 22 countries.

Source: FDI, Externalities and Economic Growth in Developing Countries, Nagesh Kumar and Jaya Prakash Pradhan, RIS, (2002).

Similarly, the evidence on whether FDI leads to an increase in employment is mixed. Overall, foreign investors seem to have created jobs. According to UNCTAD (1999), foreign affiliates of TNCs have generated direct employment for about 19 million people in developing countries in 1998.[7] TNCs also generate indirect employment through enterprises, which are suppliers, subcontractors or service providers to them. Indirect employment created by foreign affiliates is between one to two times greater than direct employment created. The quality of employment however varies widely especially in terms of wages and benefits, and safety and health matters.

UNCTAD Trade and Development Report 2002 highlights the example of foreign funded enterprises (FFEs) in China. In the last few years, China has seen a rise in the number of FFEs, which are mainly owned by East Asian investors. The share of their processed exports in total exports was over 55 per cent in 2000. Their contribution to job creation is however modest. In 1996, their share in total Chinese exports accounted for about 9 per cent of GDP but their share in the total labour force was less than 0.8 per cent. These are generally small and medium sized enterprises using capital intensive technologies, export oriented and involved in the last stages of processing and assembly operations.

Measures of other parameters give out similar mixed results. The impact of FDI on economic growth and development is the sum of all these effects.

FDI and other forms of capital flows

FDI is usually sought to augment the shortfall in domestic investment. Economic development requires a certain level of investment and developing countries often lack domestic resources to achieve the required level. Some developing countries may have the requisite domestic capital but seek external capital for transfer of technologies and management techniques to achieve national technological development.

International capital flows are more volatile by nature than the domestic ones. Compared to other forms of international capital flows such as portfolio investment, FDI tends to be less volatile. Therefore it would seem prudent for developing countries to depend on FDI as a source of external finance.

During the Asian financial crisis of 1997 there was a sharp decrease in private external capital flows to emerging East and South-East Asia. Net private foreign bank lending and portfolio equity investment turned negative in 1997 for the countries most affected by the crisis: Indonesia, Republic of Korea, Malaysia, Philippines and Thailand. Their FDI flows however remained positive and continued to add to existing stock. In fact at the height of crisis in 1997, total FDI inflows to the five most affected countries remained at a level similar to that of 1996.[8]

Though it is more stable than other forms of capital, FDI is usually more volatile than domestic capital. In addition, there could be other problems associated with FDI such as adverse balance of payments due to repatriation of profits by foreign investors. Benefits of FDI can be best maximised if FDI inflows to a country grow in harmony with domestic investment.

What does civil society believe?

In the past few years, civil society organisations (CSOs) have played an important role in national and international economic development. CSOs have been doing research and advocacy work and working closely with governments of developing countries on investment issues. They have identified problems such as corruption, regulatory failure and inappropriate policies, which adversely affect FDI flows and have also addressed the issue of the impact of FDI on development.

Given the controversial role of FDI, the civil society perceptions of FDI often play an important role in a country's policy-making process. CUTS has been conducting a civil society survey on perceptions of FDI in seven developing countries and transition economies as part of its "Investment for Development"[9] project. The preliminary results of the ongoing survey are as follows.

Civil society in all the project countries[10] with the exception of India thinks that FDI has contributed to the national economic development of the country. Civil society in India has grave reservations about the historic role of FDI in the national development, whereas Bangladeshi civil society thinks FDI has played a more positive role in the long term (10 years) than in the short term (2 to 5 years).

Civil society believe that FDI brings in valuable new management techniques and technologies, that it is a reliable source of foreign capital and, that it increases access to world markets and competitiveness of the host economy. Civil society, however, is not sure whether FDI increases domestic investment and exports, reduces imports and profit opportunities for domestic companies, or of the environmental impact of FDI.

Civil society also believes that to increase FDI flows to their countries, the following policies and strategies should be strengthened: environmental, labour, competition and sectoral policies, intellectual property rights (IPR), support to local businesses to upgrade technology and developing countries' access to finance.

Despite reservations of some respondents about the historical role of FDI the civil society generally is in favour of FDI. A clearer picture will emerge when the civil society surveys are completed by January 2003.

Factors which might hinder FDI

Factors, which could hinder FDI flows to Asia are, depression in the world economy, negative perceptions of the countries of the region, poor infrastructure, poor profitability due to a low rate of return or high costs, political instability and rigid labour regulations.

The importance of these factors varies from region to region. For example, the poor FDI flow to West Asia partly reflects political instability and risk, whereas poor FDI flows into South Asia particularly after the September 11 terrorist attacks reflect poor perceptions among foreign investors of the stability of the region's investment environment.[11]

Sometimes it is difficult to pinpoint such factors. Angola is a case in point. This southern African country is at present torn by a civil war and has reportedly has a very corrupt regime but attracts the highest FDI in the continent. Brazil, despite the shaken confidence of foreign investors in the region following the Argentine economic crisis, attracted the second highest FDI among developing countries in 2001.

Again, openness of a FDI regime or the political regime in a country does not indicate whether FDI will flow into a country. A country such as China has received much more FDI than India with a more liberal FDI regime.

Measures to maximise benefits from FDI

It is as important for countries to take measures to maximise benefits from FDI so as to attract higher FDI. Benefits from FDI could be maximised if efforts are concentrated on attracting long term productive FDI. Short-term profit making FDI may destabilise developing countries and certain types of FDI such as resource seeking FDI in mining activities, may not add any productive value to the economy. The quality of FDI is important in this regard. The quality of FDI could be measured by the extent of localisation of investors' product, their contribution to the development of modern industries and extent of export-orientation and, research and development activity of companies.[12]

To attract quality FDI, a developing country must ensure that a sound investment climate is in place. A sound investment climate requires a sound macroeconomic environment, appropriate institutions and basic infrastructure.[13] If these conditions are not properly in place, the cost of transacting business usually increases and thus profitability reduces.

Macroeconomic environment: A sound macroeconomic environment is said to be "necessary but not sufficient" to provide a stable and secure investment environment. Developing countries should ensure sound monetary policies, strong fiscal accounts and stable exchange rates to this end. Sound monetary policies will keep inflation under control. Strong fiscal accounts will provide funds for counter cyclical spending, building of safety nets, redistribution of incomes and provision of public goods such as infrastructure services. Stable exchange rates are required as large fluctuations in exchange rates can undermine investment incentives.

Appropriate institutions: Often developing countries lack proper institutions to set up and maintain an effective investment environment. It is important to have institutions to maintain strong property rights and the rule of law, to enforce contracts, and a regulatory structure which would prevent corruption and enforce rules.

The problem with a large number of emerging economies is that while they have proper FDI policies, their implementation is poor. Again for large federal countries such as India, there could be a gap between the policy and regulatory structures of the federal and provincial governments. It is important that the countries fill such gaps in their FDI regime by strengthening their existing institutions or setting up appropriate ones. It is often felt that if a government lacks the ability to regulate effectively, it should have a small regulatory set-up with minimal regulation.[14]

Basic infrastructure: Inadequate availability of basic infrastructure such as power and water supply, roads and bridges, transport and communications deters foreign investors from entering a country. The responsibility to provide adequate infrastructure usually lies with the government in developing countries. In recent years, due to the inability of the government in providing adequate infrastructure, domestic and foreign investors are being invited to the sector. However, the very factors, which deter private investors in other sectors, deter those in the infrastructure sector.

Social infrastructure such as literacy and education is important as it determines the quality and availability of labour.

The East Asian FDI boom before 1997 showed that accrual of benefits of FDI largely depends on factors such as per capita income and growth and the availability of appropriate infrastructure and labour, rather than on a liberal trade and investment regime and incentives.

The East Asian experience also shows that there is a need for selectivity and a strategic approach in attracting FDI in line with national development priorities, and socio-economic and technological development. South Korea, for example, did not receive large volumes of FDI during the Asian boom before 1997 but it used its investment strategically to achieve technological development. China, Malaysia and Singapore received larger volumes of FDI than South Korea. They too ensured that flows are in line with their national development priorities.[15]

FDI is not a panacea for all economic evils plaguing a country. The quality of FDI is important. It is also important to devise national strategies so as to attract right kinds of FDI in right sectors. One important factor is the attitude of officials towards FDI. Though China does not have a very liberal FDI regime, it has a welcoming attitude towards FDI.

Conclusion

Emerging Asia has the potential to attract a large volume of FDI in the next few years provided certain external and internal conditions are fulfilled. However the region is not a homogenous one. The whole region can be divided into several sub-regions with distinct FDI characteristics. In terms of actual FDI flows, East and South-East Asian countries are the winners in Asia, though other sub-regions also hold good potential.

It is not easy to predict the right combination of factors which would encourage or discourage FDI inflows to a particular country but some measures to attract FDI are clearly critical. For equitable economic growth, developing countries should take proper steps to maximise the benefits from FDI.

Civil society has the potential to play an important role in FDI policymaking process of a developing country. It can carry out research on FDI and help to disclose the findings for the benefit of the public at large. Governments and civil society organisations of Emerging Asia should work together to achieve the goals of high economic growth and development in the region.

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FOREIGN DIRECT INVESTMENT AND DOMESTIC PRIVATE SECTOR DEVELOPMENT IN AFRICA: THE EXPERIENCE OF TANZANIA

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Introduction

The economic reforms of Tanzania, which began in earnest in 1986, have brought about the foundation of an economy that increasingly relies on private sector enterprises and market forces for growth and development. The wave of reforms has been both intensive and extensive covering all aspects of the economy. These reforms include financial sector reforms, privatisation of parastatals, civil service reforms, good governance initiatives, tax system reform, adoption of multiparty system and institutional reforms such as the establishment of the Tanzania Investment Centre (TIC) and Tanzania Revenue Authority (TRA).

Tanzania has enacted favourable laws and regulations to suit the needs of investors and keep pace with the new dynamic business world. Conflicting laws and regulations have been rectified and made clearer and easier to interpret. These includes the Tanzania Investment Act (1997); Investment Regulations (2002); Petroleum (Exploration and Production) Act, 1980; Mining Act, 1998; Tanzania Revenue Authority Act, 1997; Land Act, 1999; Financial Laws Miscellaneous Amendments Act, 1997; to mention a few.

Initiatives have been taken to reduce bureaucratic delays and uncertainties in servicing the business sector and in ensuring rule of law, transparency and regulatory consistency to all; Thus for example The Public Sector Reform Programme (PSRP) has as one of its main goals the empowering of public servants so that they take timely decisions in accordance with their levels of responsibility and authority.

In response to the continually improving economic performance and investment climate created by economic and political reforms and the generous package of investment incentives, Tanzanian's Foreign Direct Investment (FDI) inflows have increased impressively. According to the latest World Investment Report 2002 (WIR 2002), Tanzanian's inward FDI stock in 2001 reached a record high of US$224 million, placing the country among the top dozen recipients of FDI in Africa, just behind oil producing countries and South Africa. Tanzania FDI flows have increased from US$23 million in 1995, rising to US$193 million in 1999, US$224 million (2001) and projected to top US$300 million in 2002. This is despite the fact that the whole of Africa received only 2% of total global inflows in 2001 while global FDI plunged by 51% from US$1.3 Trillion in 2000 to US$735 million last year (2001).

Among African countries, South Africa leads the continent in attracting FDIs as it attracted US$6.6 billion last year followed by Morocco (US$2.7 billion), Algeria (US$1.2 billion), Angola (US$1.1. billion), Nigeria (US$1.1 billion) and Sudan (US$574 million). Others are Egypt (US$510 million), Tunisia (US$486 million), Côte d'Ivoire (US$257 million), and Mozambique (US$255 million). With this reputable performance with FDI, the challenge for Tanzanian now is to push FDI to new frontiers, to attract high levels of FDI inflows and to increase the scale and scope of the benefits of these inflows to its economy.

It is therefore very encouraging for us at TIC as a business-support organisation to note that government is on top of the situation and has intensified action aimed at seriously tackling the remaining obstacles that contribute to a lingering negative business climate. Implementation of the envisaged programmes for Business Environment Strengthening for Tanzania, in short BEST, which begins early next year, is expected to further transform the business operating landscape of Tanzania rapidly and irreversibly.

Building and stabilising an enabling political and economic environment

Background overview

Tanzania achieved independence in December 1961 with a severely underdeveloped economy and a limited infrastructure. The economy was heavily dependent on agriculture, which accounted for more than 70% of Gross Domestic Product (GDP). Major export crops were coffee, cotton, tea, cashew nuts, sisal, maize, rice, wheat, cassava and tobacco. Primitive technology together with dependence on climatic conditions, however, limited cultivation of crops to only 6% of the arable land area. Industry accounted for 15% of GDP and was mainly limited to processing agricultural products and manufacture of light consumer goods.

In an effort to create socially equitable and rapid development, Tanzania became an early proponent of African socialism, **Ujamaa** (roughly meaning togetherness), launched in 1967 under the banner of the Arusha Declaration, with nationalisation of banking, finance, industry and large-scale trade; marketing and export of crops through Boards, and resettlement of peasants in communal villages known as **"vijiji vya ujamaa".** By 1975, rural Tanzania had been carved into 8300 villages. While the Ujamaa period is widely regarded as an economic failure, it is noteworthy to remember that the enduring values of National unity, social cohesion and a united purpose were successfully planted then. It is this strong sense of unity which has spared Tanzania scourges of civil strife that have commonly affected a large number of African countries, and has formed the bedrock upon which Tanzania was able to carry out radical economic reforms with spectacular success without undergoing the social upheaval that so often do take place whenever developing countries attempt major political, social or economic transformation.

Tanzania was able to record progress in education and health but, after an initial boom, the formal economic base shrank; production fell and the parallel economy became a way of life. Falling export prices in the world market coupled with appreciating real exchange rates and the Government's policy shift to favouring food crops over export crops led to foreign exchange shortages, drop in imports of intermediate goods and raw materials led to sharp cutbacks in production of goods, and to a deterioration of the country's frail infrastructure. These factors worsened Tanzania's economic position and created strong inflationary pressures, an accumulation of external payments arrears and an increased reliance on external borrowing. Average inflation rate rose to 38% while the Government external debt reached a record US$9 billion *[Bank of Tanzania (BOT)* review *of Political and Economic Performance 1961-1981].*

The Ugandan war (1978-79), decline in commodity prices and failure of the policy itself in economic terms brought the country to the verge of bankruptcy by 1984/85. However, reforms to reverse the downward trend were initiated on coming into power of the second phase Government in Tanzania led by Ali Hassan Mwinyi (The President). In 1986, new policy directions and International Monetary Fund (IMF) backed structural adjustment programmes (at a considerable cost to social sector programmes) helped to integrate the parallel economy and to stimulate growth.

Recent developments

Tanzania has made substantial progress over recent years towards putting together into place a general policy environment, which is more favourable for private sector expansion and sustainable economic development. The economic recovery programme announced in mid 1986 has generated notable increases in agricultural production and financial support for the programme by bilateral donors. The World Bank, the International Monetary Fund, and bilateral donors have provided funds to rehabilitate Tanzania's weak economic infrastructure.

Since the 1995 multiparty elections in Tanzania, President Mkapa's Government has established as its priorities the development of a stable macroeconomic environment, privatisation, the elimination of institutionalised corruption, the promotion of good governance, the establishment of multiparty democracy and the development of civil society. The Government's macroeconomic objectives have had the following targets:

- attain high rate of annual GDP growth averaging eight to nine percent per annum;
- reduce inflation, and maintain a low inflation rate of a single digit figure;
- strengthen the country's balance of payments position. This includes raising the proportion of imports covered by export earnings;
- achieve fiscal stability through prudent fiscal management. Control of public expenditures, avoidance of domestic bank borrowing to finance budget deficits and strengthen domestic revenue collection;
- maintain monetary stability and strengthen the financial sector.

In late 1996, the Government signed a Structural Adjustment Agreement with the International Monetary Fund and the Paris Club creditors wrote off US$1 billion and rescheduled repayment of US$700 million of Tanzania's external debt which still remains at US$8 billion (*BOT Annual Report 1999/2000*).

The country shifted from its previous reliance on control mechanisms to a predominantly market orientation, particularly with respect to investment, the external sector, monetary management and agricultural marketing arrangements. Restrictive regulations and controls have been removed. The foreign exchange system has been completely liberalised for payments and transfer for current account international transactions. Progress has been made with the development of a more market-oriented financial system with the liberalisation of interest rates. A substantial number of private banks foreign and local, insurance companies and other financial intermediaries have been established in Tanzania to match and facilitate the country's current pace with regards to investment and production. The establishment of the Tanzania Revenue Authority with the assistance of bilateral donors as an autonomous body in tax collection has increased the government tax collection by more than 200%, that is from about US$0.4 billion per annum in early 1990s to US$1.1 billion in 2001 (*The Economic*

Survey 2001; President's Office – Planning & Privatisation). As a result of failure of the parastatals to deliver and their heavy dependence on bank credits, Government grants and loans for survival and growth, the Government embarked on a divestiture programme. The Government decided to withdraw from the business sector and decided instead to play the role of policy co-ordinator (**Privatisation**). As at October 2001, a total of 326 divestiture transactions had been completed, comprising 243 divested units and 83 non-core assets sold. The divested units included 200 handled by the Presidential Parastatal Sector Reform Commission and 44 liquidated by LART (*PSRC Annual Review 2000/01 and Action Plan 2001/02*).

Domestic output

Developments in various sectors of the economy indicated that the targeted GDP growth of 5% was achievable. Aggregate supply as measured by GDP at constant 1992 prices grew at 5.6% in 2001 compared with a growth rate of 3.3% recorded in 1997 (see Appendix Graph 1).

Given the annual average population growth rate of 3.0%, real per capita income in Tanzania Mainland grew at a higher rate of 2.7% in 2001 compared with a rate of 0.5% recorded in early 1990s. According to the statistics agriculture, mining, construction and the trade, hotels and restaurants sectors recorded substantial growth rates. The agriculture sector grew by 5.5% in 2001 compared to 3.4% recorded in 2000. The increased growth in the sector is attributed to relatively good weather conditions during 2001, which boosted both food and cash crops production. For other sectors and their contributions to the GDP (see Appendix Graph 2).

Inflation and the exchange rate

The headline inflation as measured by changes in the consumer price index, declined from around 30% in late 1980s to 5.2% in 2001 making it the lowest inflation rate achieved over the past twenty years.

Table 1. Tanzania Shillings (Tshs) v/s US Dollar from 1993 to 2000

	1995	1996	1997	1998	1999	2000	2001*
Tshs per US$	595.1	608.3	631.0	665.5	746.1	807.7	896.0
% of decrease in value		2.2	3.7	5.5	12	8.2	11

* Estimate

Source: The Bank of Tanzania – Economic and operations report for the period ended 30 June 2000.

Programmes and strategies adopted

Policy reforms which have been implemented from the late 1980s include:

- Trade liberalisation
- Financial sector reforms
- Privatisation
- Civil service reforms and enforcing accountability
- Decentralisation (improve participation in decision making)
- Measures against corruption [empowerment of Prevention of Corruption Bureau (PCB)]
- Tax reforms (formation of the TRA)

These reforms have enabled Tanzania to improve efficiency and reduce impediments to growth. To accelerate economy growth, reduce poverty and create an enabling environment conducive for private sector development, this Government adopted different programmes such as:

- Planning Commission Composite Development Goal for the Tanzania Development Vision 225 (Feb. 2001)
- Government of Tanzania Programme for Business Environment Strengthening Programme for Tanzania (Feb. 2001)
- Ministry of Finance and Economic Affairs, Zanzibar vision 2020 (Dec. 1999)
- Establishment of a National Business Council (Tanzania National Business Council)
- Liberalization of the Financial Sector
- Establishment and improving the performance of a "One Shop Centre" investment facilitation servicing and promotion
- Structural Adjustment Programme to foster macroeconomic stability
- Stock market formation and Development (Dar es Salaam Stock Exchange)
- Targets to reduce poverty and stimulate pro-poor growth through the extended highly indebted poor countries initiative and the related Poverty Reduction Strategy (PRS) which support National Poverty Eradication Strategy
- Tanzania Assistance Strategy – giving indications of priority areas for external support
- Strategies towards achieving the goals set by vision 2025
- The public sector reform programme to support the attainment of a high rate economic growth and ensure that delivery of quality services within the priority sectors conforms to public expectations for value, satisfaction and relevance by the end of 2011

Public sector reform programme (PSRP)

The Government of Tanzania has been implementing various reforms across its economic as well as social sectors to expedite the development of the country.

The Public Sector Reforms Programme of Tanzania, which was officially launched by His Excellency, the President of the United Republic of Tanzania in June 2000 aims to transform the public service into an excellent and result oriented public service.

The PSRP has been designed in pursuit of the vision, mission, core values and guiding principles that have been promulgated in the new public services management and employment policy.

PSRP programme requires public service that is performance based outcome and as such Ministries are required to use open system of appraisal known as Open Performance Review Appraisal System. This replaced to the old system of confidential assessment. The new system is transparent to avoid victimisation of the staff. Another key aim of the programme is to hive off the Government the non – core services by outsourcing them to the private sector.

It is believed that under the current reform programmes, the private sector has a crucial role to play and if well utilised it will become an engine for growth.

Consequently the programme has started to roll – out some of the non – core services to private sector, in this regard Private Sector Participation (PSP) has been implemented in several Ministries while capacity building for other Ministries, Departments and Agencies (MDAs) to carry out PSP has been undertaken.[1]

It was agreed that MDAs identify the core services and time for processing such services. This has improved the speed and efficiency of the service delivery to units. Following this, the civil service department launched its Client Service Charters on Dec 2001. Another 14 Ministries and Agencies have already completed their Client Service Charters and will be launched in the near future. An additional major component of the programme is the establishment of Executive Agencies which will operate as autonomous Government institutions on a self funding basis and thus relieve Government's obligation of spending public funds to run them.

In the context of the above, it is projected that the programme will have three overlapping phases ending in year 2011:

- Phase 1: Installing Performance Management Systems (2000- 2004)
- Phase 2: Instituting a Performance Management Culture (2005 – 2008)
- Phase 3: Instituting Quality Improvement Cycles (2009 – 2011)

The six major components of the programme as defined in the medium term strategy and action plan are:

- Performance Management System Component
- Restructuring and Private Sector Participation Component
- Executive Agencies Component
- Management Information System Component;
- Leadership, Management and Governance Component; and
- Programme Co- ordination, monitoring and Evaluation Component.

Private sector development

The Vision 2005 document spelling out Tanzanian's long-term development policy, clearly identifies the importance of the private sector as the engine for economic growth and in the creation of jobs and additional National income.

The private sector in Tanzania is made up of foreign investors and domestic investors. The domestic investors consist of a small number of formally registered establishments, mainly in urban areas, and the unregistered informal establishment. Most of the businesses are informal including some small, medium and micro level enterprises, operating in urban as well as rural areas.

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1. PSRP Annual Report June 2001 to June 2002 Civil Service Department.

The redistribution of roles between the state and the private sector reforms, have focused on reducing and rationalising government activities and on creating a conducive environment for private sector. Measures relating to the former include privatisation of state-owned companies, down-sizing of civil service and approved public financial management systems. Reforms relating to the latter include liberalisation of the financial services, trade liberalisation to improve competition in trading of goods, dismantling of marketing boards, and streamlining of the investment code to facilitate both local and foreign investments.

As part of the development, the private sector progressively organised itself into associations. At national level the Tanzania Private Sector Foundation has been established as a focal point for advocacy and lobbying with Government on behalf of its members.

Tanzania National Business Council

The Government has for long-time realised that the growth of the economy depends ultimately on a dynamic and robust private sector. Its ability to solve problems such as poverty alleviation, employment creation and overall welfare of the people also depends on a growing economy. A strong and dynamic private sector increases government revenue. On the other side the private sector has been calling for a less constrained operating environment, a more business friendly public service, and a platform for expressing its views in the process of planning and implementing programmes and strategies for the economic and social development.

In 2000, the Government, after consultation with the major stakeholders, started to institute a mechanism for holding regular dialogue with the private sector and other stakeholders on issues concerning the social-economic development of Tanzania. This process culminated in H.E. the President of the United Republic of Tanzania Mr. Benjamin William Mkapa inaugurating the Tanzania National Business Council (TNBC) on 4th April 2001.

The objectives[1] of the *TNBC* are:

1. to provide a forum for public–private sector dialogue with a view to reaching consensus or mutual understanding on strategic issues relating to the efficient management of development resources;

2. to promote the goals of economic growth with social equity and even development;

3. to review from time to time developments in the external and domestic business environment, the challenges they pose to Tanzania, and propose appropriate course of action,

4. to exchange views on the prevailing operating and regulatory environment, and propose ways to facilitate the public service, to improve on service delivery and make the civil service business friendly;

5. to review and propose changes in the policy environment to enhance the attractiveness of Tanzania for both domestic and Foreign Direct Investment (FDI), and improve the competitiveness of Tanzanian products in the world market;

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1. Speech by the President at the Inauguration of TNBC April 2001.

6. to encourage and promote the formulation of co-ordinated policies on social and economic matters, including consideration of existing and proposed economic, legislation, and make appropriate recommendations; and

7. to consider any other matter deemed relevant to the achievement of the above objectives.

In pursuit of the above objectives the TNBC shall,

1. cause to be conducted, such research or survey or study any aspect of social and economic development policy as it may deem fit;

2. review specific research, reports of policy proposals submitted is it by any of the consultative bodies. It may also call for and consider any such reports as it deems necessary to provide a clearer picture of affairs before it;

3. set targets as well as performance benchmarks for implementing decisions or agreements reached, including assignment of responsibilities;

4. monitor and evaluate implementation of policies and measures agreed upon, as to their effectiveness and outcomes;

5. the private sector is now working in partnership with the government in Taxation, the regulatory framework and also in day-to-day problem solving of business bottlenecks. In this regards nowadays the Government's annual budget measures are only concluded after genuine dialogue between the Government and the private sector. In addition, the Government through regular dialogue with the private sector (in meetings such as *The International Investment Forum, Local Investment Forum, Focus Group Meetings* and *Task Force on Capital Goods Commission*) has so far managed to solve many Private sector problems on a fast track basis.

The Tanzania investment centre (TIC)

In its effort to reform the economy and create a favourable climate the Tanzania Government acted aggressively on recommendations made by two reports on exports published in November and December 1996. The reports revealed astonishing experiences with regards to the constraints in the legal and regulatory framework in Tanzania. The two reports are:

1. The legal, administrative and institutional components of the review of investment policy and law, prepared by Dr. Hawa Sinare and Dr. F. Ringo under the auspices of Economic and Social Research Foundation.

2. The Investor Road Map of Tanzania prepared by the TSG Group, a team of experts from United States and funded by USAID.

The policy review carried out by ESRF, helped to launch the new National Investment Promotion Policy formulated in 1996 based on the ESRF report which reviewed investment promotion and facilitation activities carried out under the investment code of 1990, by the Investment Promotion Centre.

As regards the review of the investment code, the legal administrative and institutional component review come up with a number of issues that needed to be rectified for improving the business investment environment in Tanzania.

One of the major findings of the study pointed-out the existence of about 600 pieces of legislation that were perceived to be anti-business.

The launching of the Tanzania investment policy (1996) paved the way for the enactment of the Tanzania Investment Act 1997 which established the Tanzania Investment Centre (TIC) to be "the primary agency of Government to co-ordinate, encourage, promote and facilitate investment in Tanzania and to advise the Government in investment related matters". All Government departments and agencies are required by law to co-operate fully with TIC in facilitating investors.

Investor Roadmap 1996

The investor roadmap 1996 report revealed procedural and administrative barriers to investment in Tanzania. It outlined the steps required for each agency involved in business set up, and highlighted the requirements, fees and expected delays an investor would encounter on his way to investing in the Country. By then Tanzania ranked very low when compared with other Africa Countries in terms of investment facilitation and servicing. These shocking revelations of the 1996 roadmap report forced government departments to re-examine their processes and institute appropriate changes.

Subsequently the **1999 Roadmap Study**, which revisited the earlier one, enumerated the following improvements in simplifying procedures:

- Obtaining a Class A resident permit, the process took 2 days to 2 weeks in 1998 compared to 2 to 6 months in 1996

- Obtaining a letter of offer from Ministry of lands the process took 3 to 4 days in 1998 compared to 1 week in 1996

- The Certificate of Incentives (for investment) took between 3 to 14 days to be obtained from TIC in 1998 compared to 3 to 4 months from IPC.

TIC as a one-stop facilitative centre

After working on the recommendations made by the Foreign Investment Advisory Services (FIAS) report of early 1999 and the investors roadmap 1999, TIC has been able to transform itself into a fully fledged one-stop centre with officials from the Ministry of Trade and Industry, Business Registration and Licensing Authority (BRELA), Lands, Immigration, Labour and TRA stationed at the TIC office attending to investors.

This arrangement eases the process of setting-up a business in Tanzania. The arrangement has also enabled the following achievements:

- certificate of incentives processing time has been reduced from 100 days to less than 14 days;

- regular visits and communication are being established between Relationship Managers (all TIC professional staff) and investors with a view of solving investors' problems, facilitating implementation and operation of their projects as well as work in partnership for improved investment environment.

In its detailed guideline (TIC – Corporate Plan 2001-2006) it envisages the transformation process to make TIC a world-class investment promotion agency that is capable of, and successful in, promoting/generating significant private sector investment for Tanzania. The Centre expects to achieve that objective by adopting a proactive approach to:

- transform itself into a fully fledged investment promotion agency;
- developing a high level of expertise in investment promotion, facilitation and servicing;
- becoming an efficient one-stop shop for facilitation and servicing of private sector investment;
- becoming a lead advocate for private sector investment and development in Tanzania;
- attracting significant foreign investment to Tanzania;
- promoting, stimulating and encouraging investment amongst the local private sector;
- advocating for the implementation of measures designed to improve the climate and environment for private sector investment in the economy.

The "Best'' programme

The Government is committed to the continued development and improvement of the investment and business environment in the country. An encouraging achievement made is the Government's endorsement of the Business Environment Strengthening Programme (BEST) for Tanzania as recommended by a DFID (UK) funded study carried out with the full involvement of both public and private sector stakeholders together with other development partners.

The programme has three main objectives:

- creating an enabling environment;
- increasing the competitiveness of Tanzania's products and Services in the international markets;
- fighting poverty by increasing Tanzania's Gross Domestic Product (GDP).

Five components of the programme include:

- achieving better regulations;
- improving Commercial Dispute Resolution;
- strengthen the Tanzania Investment Centre (TIC);
- changing culture of government;
- empowering private sector advocacy.

National Investment Steering Committee

On 11th to 12th May 2002 the Centre conducted a National Investment Stakeholders Workshop held in Sea Cliff Hotel, Dar es Salaam. One of the major recommendations made was to request Government to form a high-powered National Investment Steering Committee. This was recognized by Stakeholders as being essential in the context of Tanzania if she really wants to improve investment growth.

The Government, in an effort to improve the business environment and foster economic growth through increased investment accepted the recommendation and formed a National Investment Steering Committee to be headed by Honourable Prime Minister on 5th September, 2000. Other members of the committee are Minister of Finance, Minister of State, President's Office – Planning and Privatisation, Minister for Industries and Trade, Minister for Lands and Human Settlement Development, Attorney General, Governor Bank of Tanzania, Executive Director – TIC (Secretary). The Committee is entrusted with the role of investment policy formulation and solving problems of investors on a fast track basis.

The Committee is entrusted with the task of investment policy formulation and solving problems of investors on a fast track basis. Again this initiative is meant to provide further momentum to the investment process in Tanzania. The committee was inaugurated in May 2001.

The Committee has already proved instrumental in approving projects which have major impact either in terms of size, area or cross-sectoral requirements. The Committee has also approved a special investment incentives package for the textile industry to take advantage of AGOA and other similar arrangements.

In response to the continually improving conducive investment legal framework and the generous package of investment incentives, the TIC has between 1990 and September 2002 registered 2,076 projects worth about Tshs. 6,422.6 billion. Out of these projects 473 or 22.80% were wholly foreign owned, 674 or 32.5% were jointly owned by foreigners and locals and the remaining 929 or 44.7% are projects invested by local Tanzanians.

FDI is showing an upward trend in Tanzania, as reforms initiated in 1986 appear to have begun to firmly take hold. Tanzanian's FDI inflows have increased, improving the century's position from number 16 to 12 on the FDI list in Africa.

As per World Investment Report 2002 (WIR 2002) Tanzania between 1995 and 2000 received a total of US$1 billion in FDI, compared to US$90 million during preceding Six years – a remarkable performance for a country that was receiving hardly any FDI just 10 years ago. As per WIR 2002, Tanzania attracted US$224 within in the year 2001, thus recorded US$1.404 billion of FDI stock as of 2001 just below oil producing countries and South Africa.

As FDI has increased, the qualitative impact of FDI on the economy has also, become noticeable, especially in the industries where FDI is concentrated. In mining, FDI has served as an engine of growth and has helped increase gold exports. In banking, it has contributed to modernisation of the industry.

Corporate responsibility issues

Through the public/private sector interactions explained above there has been a general agreement on the following issues as underpinning the corporate responsibility agenda:

(1) Tax evasion/corruption

Tax evasion through collusion and corruption enabling cheating on imports (underdeclarations and deliberate mis-categorisations) fraudulent sale of tax-exempt goods and false accounting for tax cheating.

(2) Cheating on imports

Importation of junk spares, cheap substandard parts, expired chemicals etc. which leads to manufacture and assembly of dangerous goods and substandard articles.

(3) Bad labour practices:

- refusal to allow unionisation by obstructing trade union representation at work places;
- perpetuating harsh work conditions e.g. abrupt sackings, very low pay, no pension benefits; keeping workforces on temporary terms for prolonged periods;
- perpetuating employment of foreign staff at the expense of qualified local staff;
- absence of genuine training and advancement programmes for local professionals.

(4) Racial discrimination

This manifests itself in several ways:-

- unequal pay and privileges based on racial grounds;
- separate canteens, segregated menu or toilet facilities based on race;
- victimisation of local female staff particularly in the hotel industry and some factories;
- racial insults and abusive language on workers.

(5) Safety

- Unsafe conditions at work-places e.g. staff being forced to work without protection gear against dust, chemicals, heavy objects hazards etc.

(6) Outsourcing Supplies and Services

Confining subcontracts of supplies and services to foreign firms instead of using local consultants, contractors and service providers. It should not be forgotten that investment is more if welcome so that local capacities are enhanced. It is unacceptable that investment should be used to constrain local capacities and perpetuate dependency on external capacities.

All businesses are encouraged to adhere to good corporate citizenship by avoiding malpractices mentioned above. Dialogue on these matters is open and frank. TIC intends to have government set up annual award recognitions for firms that demonstrate high standards of corporate responsibility. Details are being worked out for implementation starting year 2003.

Small and medium-scale enterprises' (SMEs) development

The government strategy for promoting SMEs' development has changed from a strategy of direct intervention to that of policy support and facilitation. Lead roles have been assigned to private sector institutions and non-government organisations (NGOs).

Apart from their effectiveness in creating jobs at low capital cost, SMEs contribute significantly in terms of provision of goods and services; facilitating forward and backward linkages between economically, socially and geographically diverse sectors and providing opportunities for the development and adaptation of appropriate technology.

For example, the Tanzania breweries industry stimulates the packaging, transport, sales and distribution industries at the retail level. FDI in edible oil industry has linkages effects in that it supports oil-seed farming, oil processing and the use of its by-products in the manufacture of animal feeds. In fishing industry, small scale fishermen have not only improved their fishing methods arising from the technology spillover from big fishing/fish-processing companies but also have become suppliers to the large fishing/fish-processing companies. It is agreed that all these linkages have a highly positive effect on the economy.

Governance and human rights

Tanzania adopted political pluralism in 1995, which provide an additional "watch dog" in policy formulation, decisions on implementation of policies and the way the public sector is run.

Tanzania has adopted the National Framework on good governance with emphasis on:

- Promoting participation of people in decision making
- Promoting the private sector
- Cherishing the principles of constitutionalism, rule of law and administration of justice and protection of human rights
- Promoting gender equality
- Building a culture of accountability, transparency and integrity in the management of public affairs
- Promoting and observing positive principles of electoral democracy
- Building capacity of public service institutions/ agencies to deliver services efficiently and effectively

Measures taken to improve economic Governance include

- Implementation of an integrated Financial Management System
- Adopting an inclusive Public Expenditure Review/ Medium Term Expenditure Framework process
- Revision of Public Finance Management and Public Procurement Act
- Civil Service Reforms
- Local Government Reform Programmes
- Local Sector Reform Programme; and
- Setting up a Good Governance Co-ordination Unit

In addition the Government is working with development partners in the process of finalising a framework for implementing and monitoring progress in improving governance.

Human rights

Democratisation has led to a strong emphasis on human rights issues and Tanzania has ratified the most important international conventions and rules on human rights.

Following emphasis in democratisation, human rights and good governance, Tanzania Government on May 2001 enacted the Commission for Human Rights and Good Governance Act; which instituted the Commission for Human Rights and Good Governance as a "watch dog" for Human Rights and Good Governance matters.

Investment guarantees and settlement of disputes

Investments in Tanzania are guaranteed against nationalisation and exploitation.

Tanzania is a member of Multilateral Investment Guarantee Agency (MIGA) and International Centre for Settlement of Investment Disputes (ICSID). In that regards, any dispute arising between the Government and Investors are settled amicably through negotiations or may be submitted for arbitration before the international organisations, such as MIGA or ICSID.

In additional the Tanzania Government has established a **Commercial Court** and **Tax Appeal Board** to deal with Commercial disputes resolution and solving tax disputes respectively.

Table 2. Dispute between government and investor
(Methods of arbitration)

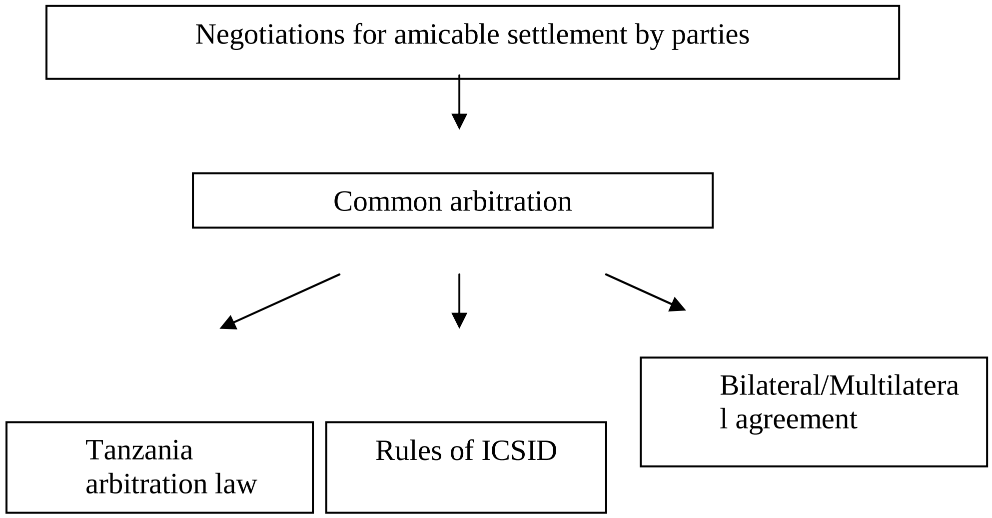
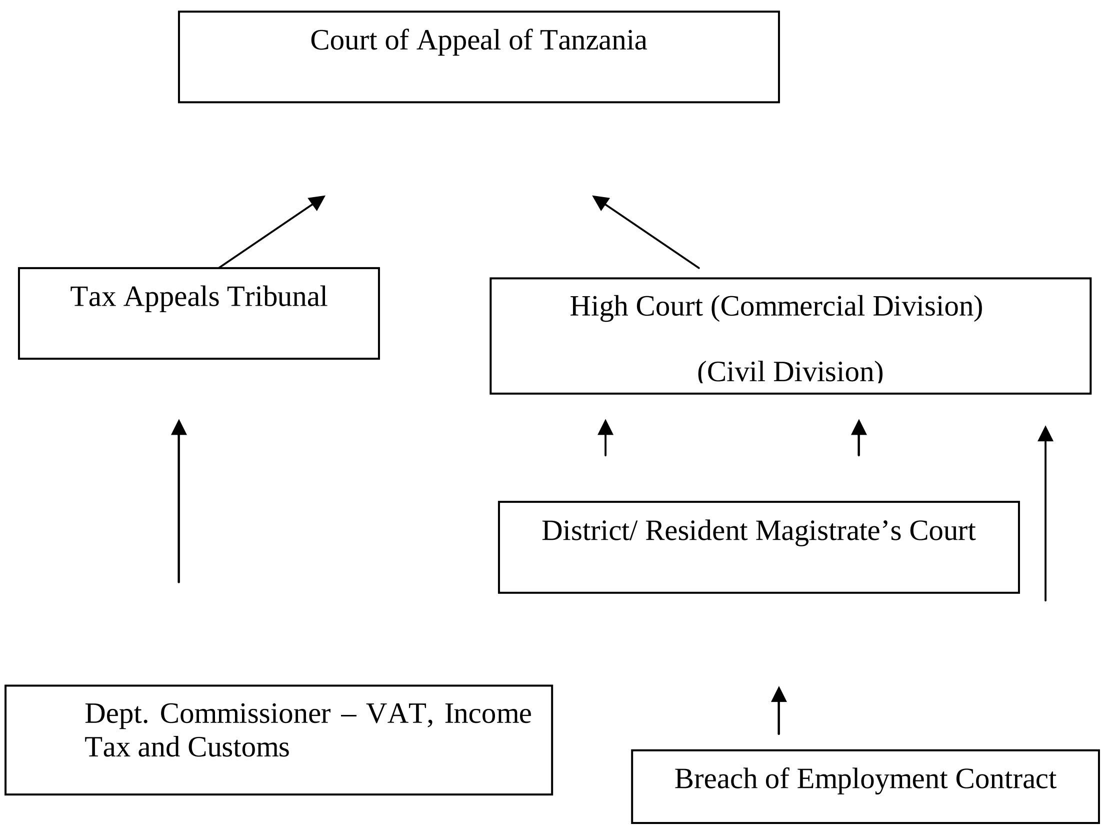


Table 3. Tax and commercial dispute
(Methods of arbitration)



Remaining bottlenecks to FDI and future challenges

Issues which constitute impediments to investors as reported in different reports (such as the1999 investor roadmap and the 2001 FDI Report carried out by BOT, TIC and NBS) that need to be addressed to install Tanzania as a top investment destination are:

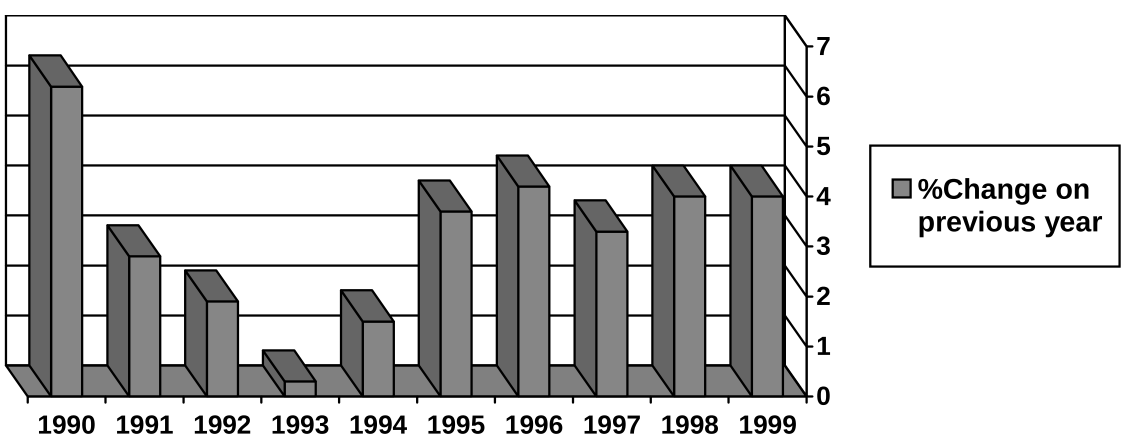
- Poor infrastructure
- Cumbersome bureaucracy
- High transaction costs (emanating from petty corruption, import/export procedures, business regulations, fiscal regulations, planning processes, legal system, bureaucracy etc).

Future challenges

From TIC's standpoint, we see Tanzania's investment efforts in the immediate future being directed towards the following:-

- Simplifying the business-operating environment of Tanzania by implementing the BEST programme already described above.
- Attracting large-scale quality investors in the agricultural, tourism and infrastructure sectors through a carefully worked out targeting campaign.
- Expediting economic infrastructure construction using private sector support.
- Skills upgrading through intensified training in business and operational management and in other modern disciplines of a modern world.

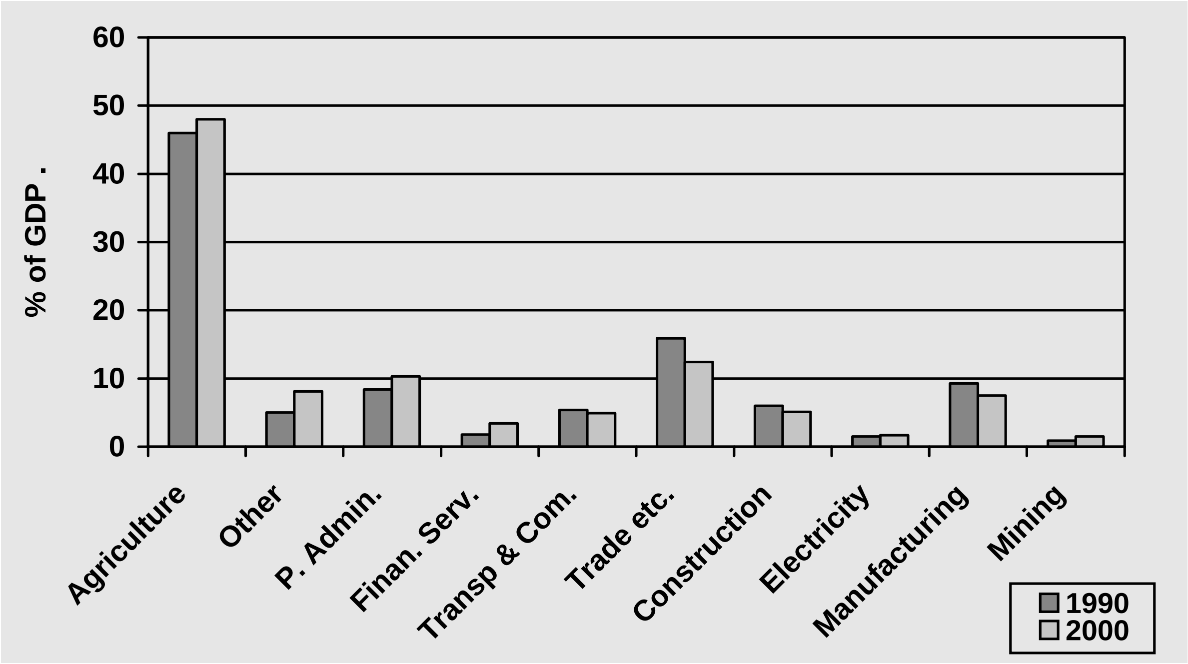
Appendix Graph 1. Gross domestic product (GDP) growth



- GDP growth rate remained relatively low around 4.1% in the 1990s.
- As a result growth has generated only minor increases in per capital income and effects on poverty levels have been insignificant.

Source: Bank of Tanzania

Appendix Graph 2. Economic performance by sector



•GDP continues to be dominated by Agriculture, Trade and Public Administration.

•Agriculture contributed 48% of total GDP in 2000 which was the same as of 1992.

•The share of public administration has risen from 9.2% in 1992 to 10.3% in 2000.

•The mining and construction industries experienced the strongest growth in 2000 recording rates of 16% and 12%.

Source: Bank of Tanzania

Appendix Table 1. Basic economic statistics – Tanzania

	1995	1996	1997	1998	1999	2000	2001
Population (millions)	27.5	28.3	29.1	30.0	30.9	31.9	32.9
GDP (factor cost) Tshs billions	2796.6	3452.6	4286.8	5125.3	5977.7	6663.7	7590.8
Real GDP Growth, % change	3.6	4.2	3.3	4.0	4.7	4.9	5.6
GDP per capita (at current prices – Tshs)	101 696	121 999	147 312	170 844	193 453	208 893	231 426
Exchange rate (US$1 to Tshs)	595.1	608.3	631.0	665.5	746.1	807.7	896
Consumer Price Index (%)	28.4	21.0	16.1	12.8	7.9	5.9	5.2
Balance of Merchandise Trade (US$ million)	-657.6	-448.9	-395.4	-777.5	-824.9	-672.8	-713.3
Current Account Balance (US$ million)	-589.9	-265.1	-372.3	-823.9	-738.6	-388.4	-413.5
Electricity sold (KWH million)	1547	1743	1663	1807	1693	1808	2015
Tourist Earning (US$ million)	258.1	322.0	392.4	570.0	733.3	739.0	725.0
Govt. Recurrent Revenue (Tshs billion)	448.4	572.0	627.5	689.3	777.6	861.4	1026.1
Govt. Recurrent Expenditure (Tshs billion)	470.0	606.3	669.6	791.2	808.8	1081.1	1250.1
Govt. Development Expenditure (Tshs billion)	30.1	124.6	186.6	136.5	359.9	313.4	291.9
FDI Growth (US$ million)	150.86	148.64	154.63	172.22	183.4	192.8	224.4

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