Event 1. Module 1: Introduction to Investment
Session One: Understanding the evolution of FDI and its role in development

- Explaining investment: why do firms internationalize?
- Home and host country perspectives: the economic impact of foreign direct investment on growth and development, trade, employment, and capabilities
- The different kinds of FDI, their political economy, and their impact on development
- New patterns and modalities of foreign investment
- How does the new framework developed by the IPP team of the WBG address these issues?

**Presenter:** Pierre Sauvé  
**Resource person:** Roberto Echandi
Understanding the evolution of FDI and its role in development

Vienna
October 12, 2015
Outline

• Investment policy and law: contextual considerations

• Understanding the different types of FDI and their impact on development

• New paradigms in cross-border investment activity
Investment policy and law: contextual considerations
Why are some countries rich...
...and others poor?
In 1776, when Adam Smith wrote “The Wealth of Nations”... the wealthiest country in the world was 4 times richer than the poorest.

Today the ratio is 400 to 1.

What has changed?
Understanding the growth process

• Countries grow because they produce new and improved goods and services...

• Or because they find better ways to produce those goods and services

• And retain more of the value added...

• But how do countries learn to produce new goods and services?

• And where is productive knowledge secured?
Years of schooling and per capita income 1965-2005
Years of schooling and per capita income 1985-2010

Fuente: World Development Indicators y Barro-Lee Schooling Data
Where is productive knowledge secured?

Not only at school, but through experience and repeat interaction, in the productive process itself:

Enterprises facilitate the transfer of productive knowledge
• Training workers
• Importing people with experience
• Learning as a team

The key is how to connect the domestic private sector with the international private sector in the productive process...
Choose your [parents] [mentors] [lead firms] carefully!
Key ingredients

- Human capital
- Quality of institutions/governance
- Structural composition of exports/connectivity
Investment and development: context

• FDI is today the world economy’s leading vector of integration: more goods and services reach consumers through sales by foreign affiliates than by trade alone

• A global network of over 80,000 multinational enterprises – from both developed and developing countries -- and their 800,000 foreign affiliates:
  • Produce a quarter of the world’s GDP
  • Sell more than US$25 trillion worth of goods and services, with an added value of more than US$6 trillion annually
And FDI is - by far - the largest source of development finance.

FDI, remittances and ODA to developing economies, 2000-2012

(Billions of dollars)

Source: UNCTAD for FDI and remittances and OECD for ODA.

Note: ODA from DAC members.
FDI is required both for long-term economic and social upgrading...but also to achieve sustainable development goals (SDGs) between 2015-2030

**LDCs need at least to double their levels of FDI:**
At current levels of private sector participation and growth rates LDCs will fall in short fall that will require nine-fold increase in government funding by 2030
Synergies between investment, trade and development

• Discussions of the relationship between IIAs, investment, trade and development are often rooted in false assumptions:
  
  – That investment -- in particular FDI-- is a homogenous phenomenon, and as such, its impact on development is uniform
  
  – That IIAs are also basically the same and thus, their impact on investment flows and development can also be jointly assessed
Reality is typically more complex

- There are many types of investment (and even different types of FDI)
  - Portfolio, FDI, NEMs.
- Their impact on development may vary, thus the maximization of benefits depends on the investment policies that host and home countries undertake

- There are also many types of IIAs
  - Their impact on FDI flows may also differ depending on the type of agreement and the type of FDI affected
Understanding the different types of FDI and their development impacts
Different types of investment not only generate different socio-economic impacts but also generate different patterns of trade...
Natural Resource-Seeking FDI

- **Factors**
  - Location, quantity and quality of natural resources

- **Historical perspective**
  - Oldest type of FDI, origin of the BIT
  - Developing countries’ first vehicle to integrate with international markets

- **Political economy issues:**
  - Fair distribution of gains derived from exploitation of resources
    - Sovereignty over natural resources
    - Environmental impacts
  - Enclave economics: resource-seeking FDI may not always generate strong in-country spillovers;
  - Need to focus on developing input industries/services

- **Relationship with trade**
  - This type of FDI tends to be export oriented, but local value added often tends to be limited
  - Pervasive recourse to local content policies to create linkages
Can natural resource-seeking FDI lead to development?

• Challenges
  • Need to promote forward linkages, diversification and use of surpluses to develop other sectors
  • Dutch disease
  • Diversification difficult (enclave economies)
  • Most developing countries have had limited success depending only on this type of FDI
  • Governance (rent-seeking and corruption, SWFs)

• Yet many success stories
  • Norway; Chile; Canada; Australia; New Zealand
Market-seeking FDI

**Factors**
- Market dimensions and per capita income (levels and growth)
- Consumer preferences
- Tailoring to clients and consumers where proximity is needed
- Perishable goods, beverages,
- Many services: retail distribution, financial services, etc.

**Historical perspective**
- Import-substituting industrialization spurs so-called “tariff-jumping” FDI
- Push for first wave of regional integration in the 1960s

**Political economy**
- Determined by its effect on domestic production - import competing interests are likely to resist new entry

**Relationship with trade**
- This type of FDI may be import-substituting, but in smaller economies generates needs for imported inputs.
Market-seeking FDI

• **Challenges**
  – Success occurs if there is strong competition in the domestic market, need for authorities to prevent protectionist policies and private anti-competitive conduct
  – Rarely tends to generate exports -until the domestic market is internationally competitive and saturated to push investors abroad
  – Useful to diversify the domestic economy, but is rarely a dominant engine of sustained growth
  – Opportunity to upgrade quality of local suppliers

• **Success stories:** countries that have markets big enough to grow on the basis of internal demand
  – United States; European Union; China; Japan; other BRICS
  – But all countries, big and small, tend to attract some measure of market-seeking FDI
Efficiency-seeking FDI

- **Factors:**
  - Investment will come provided countries enable firms to compete
  - Vicinity to greater markets, sea lanes, may play a key role
  - Key: location and competitiveness

- **This kind of investment tends to be:**
  - Export oriented
  - More footloose
  - Generator of jobs and foreign exchange
  - Significant potential gains in terms of expansion and diversification of export supply of host economy and transfer of technology

- **Political economy of this type of FDI**
  - Determined by the level of competitiveness of the host country vis-à-vis other potential host countries (importance of signals)
  - Increasing controversy in home countries

- **Relationship with Trade**
  - This type of FDI generates more trade of goods and services, especially of intermediates, hence imparts a liberalizing bias to host country trade policy
Efficiency-seeking FDI

• **Challenges:**
  – Due to its potential impact to transform exports and generate new GVCs and jobs, most countries in the world are constantly seeking to attract this type of FDI.
    • Key clear and well articulated promotion strategies; locational competition and incentives
  – Competitiveness and the investment climate of the host country is crucial, as it has to ENABLE firms to compete on the world market
    • Countries must enable investment entry and manage to retain FDI
    • Countries must facilitate the movement of technical personnel, experts, and traders
  – Countries must have means to ensure predictability and stability regarding export market access to investors who will tend to be importers and exporters
    • Importance of PTAs
    • Trade logistics for goods and services become crucial – trade facilitation to reduce trade costs
  – Long term sustainability requires the fostering of linkages between leading firms and domestic suppliers
    • Need to upgrade capacity of domestic private sector; design of behavioral incentives, supplier development programs

• **Success stories:** China, Hong Kong, Dubai, Mexico, Malaysia, Turkey, Singapore, Thailand, Ireland, Costa Rica
Trade liberalization and PTAs: key factors behind the expansion of efficiency-seeking investment & the rise of GVCs

Source: Baldwin 2011
Strategic asset-seeking FDI

• **Factors:**
  – Internationalization of firms
  – Increasingly globalized markets and competition
    • Tended to be “North-to-North”, but now increasingly “North-South”, and more importantly “South-South” and “South-North”

• **This kind of investment tends to be:**
  – Focused on M&A rather than greenfield
  – Politically sensitive depending on the size and type of assets acquired
  – May not always be net job-generating

• **Political economy of this type of FDI**
  – Politically sensitive depending on the size and type of assets acquired as well as the type of investor buying assets (e.g. SOEs)
  – Home country support
  – FDI screening in host countries

• **Relationship with Trade**
  – May be trade generating as a result of GVCs; may require higher levels of IP protection and enforcement
Strategic Asset-Seeking Investment

Country specific assets
- Natural beauty
- Cultural heritage
- Historical interests
- Strategic locational assets

Firm specific assets
- Branding
- Know how
- Human Capital
- Distribution networks

Tourism

Location

Firm Assets

Brand

Management

Technology
The type of investment matters, notably for the quality of employment.
New paradigms in cross-border investment activity
Latest changes in international investment activity

• Investment flows
  – Are today flowing in all directions...
  – Among new actors...
  – Through new investment modalities...
  – Increasingly blurring the boundary between trade and investment as means of accessing markets (from substitutability to complementarity)

• Impact on investment rule-making
  – Increasing judicial activism – negotiate and you shall litigate!
  – Constant evolution and adaptation of International Investment Agreements (IIAs)
  – Most recent developments in the U.S., Canada, Europe & TPP
Known ISDS cases, 1987-2014
Evolving political economy: Changes in *national* investment policies, 2000-2014
The shifting distribution of FDI inflows

FDI inflows, global and by group of economies
(Billions of dollars)

Source: UNCTAD
<table>
<thead>
<tr>
<th>Country</th>
<th>FDI Inflows 2012 (Billions)</th>
<th>FDI Inflows 2013 (Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>161</td>
<td>188</td>
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<tr>
<td>China</td>
<td>124</td>
<td>77</td>
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<td>Russian Federation</td>
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<td>Hong Kong, China</td>
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<td>Brazil</td>
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<td>Singapore</td>
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<td>Canada</td>
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<td>Spain</td>
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<td>Mexico</td>
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<td>United Kingdom</td>
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<td>Ireland</td>
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<td>India</td>
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<td>Colombia</td>
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<tr>
<td>Italy</td>
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</tbody>
</table>


Note: British Virgin Islands is not included in the ranking because of its nature as an offshore financial centre (most FDI is in transit).
The shift in FDI outflows: FDI no longer comes exclusively from the North

Shares in global FDI outflows, by group of economies, 1999–2013 (Per cent)

Source: UNCTAD
FDI outflows: Main generators

<table>
<thead>
<tr>
<th>Country</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
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<td>367</td>
</tr>
<tr>
<td>Japan</td>
<td>123</td>
<td>136</td>
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<tr>
<td>China</td>
<td>101</td>
<td>92</td>
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<td>Russian Federation</td>
<td>88</td>
<td>95</td>
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<tr>
<td>Hong Kong, China</td>
<td>49</td>
<td>88</td>
</tr>
<tr>
<td>Switzerland</td>
<td>45</td>
<td>60</td>
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<tr>
<td>Germany</td>
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<td>Canada</td>
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<td>Sweden</td>
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<td>Italy</td>
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<td>Republic of Korea</td>
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<td>Singapore</td>
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<td>Taiwan Province of China</td>
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<td>Austria</td>
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</tr>
</tbody>
</table>


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The rise of Sovereign Wealth Funds (SWFs)

Figure I.15. Cross-border M&As by SWFs, 2001–2010
(Million dollars and per cent)

New investors on the block: State-owned enterprises

- State-owned trans-national corporations (TNCs) are becoming an important source of FDI
- There are at least 650 State-owned TNCs, with 8,500 affiliates worldwide
- They represent less than 1% of TNCs, but their outward investment accounted for 11% of global FDI in 2010
- Ownership and governance of State-owned TNCs have raised concerns in some host countries, regarding the level playing field and national security, with regulatory implications for the international expansion of these companies
- Emergence of SOE disciplines in most recent mega-regional PTAs
The rising salience of State-Owned Enterprises (SOEs)

Figure I.20. Value of estimated FDI by SO-TNCs, 2007–2013
(Billions of dollars and per cent)

<table>
<thead>
<tr>
<th>Region/economy</th>
<th>Number</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>653</td>
<td>100</td>
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<tr>
<td>Developed countries</td>
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<td>European Union</td>
<td>285</td>
<td>43.6</td>
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<tr>
<td>Denmark</td>
<td>223</td>
<td>34.2</td>
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<td>Finland</td>
<td>36</td>
<td>5.5</td>
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<tr>
<td>France</td>
<td>21</td>
<td>3.2</td>
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<td>Germany</td>
<td>32</td>
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<td>Poland</td>
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<tr>
<td>Others</td>
<td>18</td>
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<tr>
<td>Other European countries</td>
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<td>Norway</td>
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<td>Others</td>
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<td>1.4</td>
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Source: UNCTAD.
Sectoral distribution of FDI: the rise of services

**Figure I.10. FDI projects, by sector, 2012–2013**

*Value of announced FDI greenfield projects*

2012: 321
- Primary: 268
- Manufacturing: 52
- Services: 25

2013: 385
- Primary: 258
- Manufacturing: 113
- Services: 29

9% rise in Services
- 14% in 2012
- 20% in 2013

*Value of cross-border M&As*

2012: 167
- Primary: 113
- Manufacturing: 52
- Services: 25

2013: 155
- Primary: 126
- Manufacturing: 68
- Services: 29

32% rise in Services
- 3% in 2012
- 7% in 2013

The rise of FDI in services

Figure I.11. Sectoral distribution of announced greenfield FDI projects, by group of economies, cumulative 2004–2013
(Per cent)

Distribution of value

Distribution of number of projects

Source: UNCTAD, based on information from the Financial Times Ltd, fDi Markets (www.fDimarkets.com).
Summing up: Investment policy - three key ideas

**Investment policy is not about choosing between foreign and domestic investment**

It is about connecting them through global value chains. Trade and investment are two sides of the same coin.

**Foreign investment is not a transaction; it is a relationship**

An investment policy strategy should not only pursue attraction, but also enable the establishment, retention and linkages with the domestic productive sector, thereby maximizing benefits from investment.

**Not all types of investment are the same**

Different types of investment have different effects on socio-economic development and thus require different policies. Countries should align the type of investment with different policies.
The investment life cycle: core areas of policy reform

- Investment Vision
- Entry
- Protection
- Incentives
- Investment Attraction
- Investment Establishment
- Investor Retention
- Regional Integration
- Linkages
THANK YOU

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Explaining investment: why do firms internationalize?

Home and host country perspectives: the economic impact of foreign direct investment on growth and development, trade, employment, and capabilities

The different kinds of FDI, their political economy, and their impact on development

New patterns and modalities of foreign investment

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**Resource person:** Roberto Echandi