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Foreign direct investment and financing for development: trends and selected issues

Issues note by the UNCTAD secretariat*

Executive summary

Foreign direct investment (FDI) is evolving with respect to its sources as well as its recipients. While the bulk of such investment originates from developed countries, new sources of FDI are emerging among developing and transition economies. Other recent developments include the offshoring of services, increased FDI in extractive industries and more FDI in infrastructure. While these trends expand the scope for FDI and associated benefits for developing and transition economies, there is growing recognition of the need to explore synergies between official development assistance (ODA) and FDI, especially in low-income countries. In large projects and in specific industries (including infrastructure), these two types of capital flows may need to be combined to maximize benefits to recipient countries. This issues note examines the opportunities and challenges emanating from the new landscape of FDI and considers national and international policies relevant to this evolving landscape. Host developing and transition economies need to assess the consequences of the evolution of FDI and effectively use it for their respective development purposes.

* This document was submitted on the above-mentioned date as a result of processing delays.

I. Introduction

1. At its eleventh session, held in Geneva from 8 to 14 March 2007, the Commission on Investment, Technology and Related Financial Issues underlined the contribution that UNCTAD could make to the follow-up of major United Nations conferences, including the Monterrey Consensus on Financing for Development (TD/B/COM.2/78, para. 14). At the same time, it recommended that UNCTAD should continue its global analysis of foreign direct investment (FDI) and its impact on development to identify productive, beneficial and effective FDI, in order to help developing countries and countries with economies in transition better understand how such investment can contribute to growth and development (para. 1). This note has been prepared in response to the recommendations of the Commission at its eleventh session.

2. Since the adoption of the Monterrey Consensus in 2002, many developing countries have seen significant improvements in macroeconomic performance, experiencing a broad-based economic growth. For example, real growth rates in gross domestic product (GDP) in African countries as a group have consistently exceeded the world average since 2001, and averaged 5 per cent between 1999 and 2008 (IMF 2007).[1]

3. FDI can play an important role in host-country economic growth and development as it can bring in not only capital but also access to technology and know-how and access to international markets. These assets are also key elements for better integrating developing countries into the global economy. FDI can directly contribute to the upgrading of the productive capacities in those countries. However, benefits are not automatic. Not all developing countries have attracted increased FDI, and not all inward FDI has generated the expected benefits in the host economies. In order to benefit fully from inward FDI, countries need appropriate institutions and policies. Furthermore, for FDI to act as a catalyst for economic and social development, it needs to be a complement to other forms of capital formation, including both domestic investment and such external resource flows as official development assistance (ODA), portfolio investment and bank loans.

4. With the mid-term review of the Financing for Development process under way,[2] this note offers a brief survey of the main developments in FDI flows which have implications for development in developing and transition economies. Special attention is given to FDI from developing and transition economies, offshoring of services through FDI, and FDI in natural resources and infrastructure. The new sources of FDI and increasing investment opportunities in the industries mentioned expand FDI flows to developing and transition economies. The note then looks at the relationship between FDI and ODA and discusses the scope for synergies between the two. The last section provides some policy issues for delegates to consider.

[1] However, there are some exceptions. For example, 15 African least developed countries (LDCs) had negative or sluggish (less than 1 per cent) growth rates in GDP per capita in the period 2000–2006.

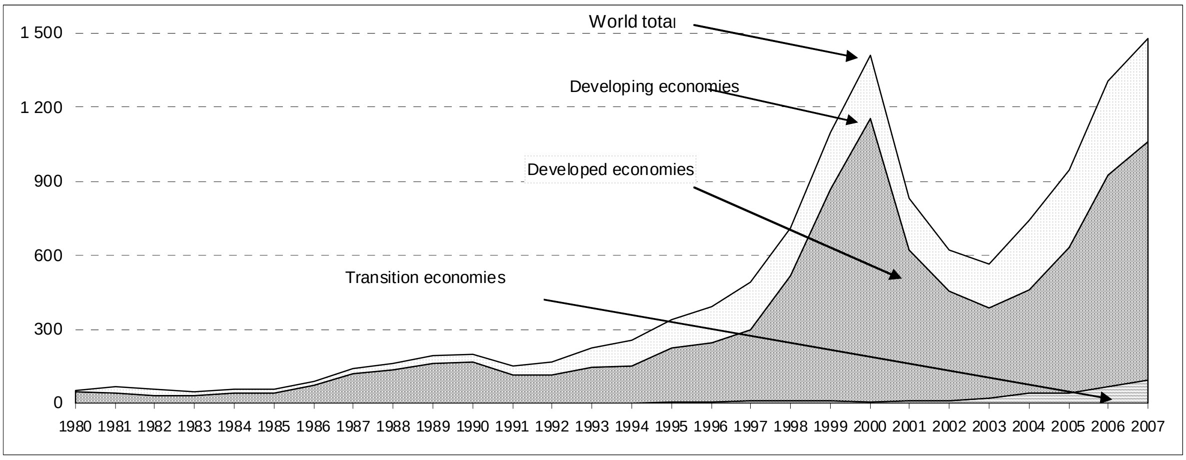
[2] The General Assembly held the High-Level Dialogue on Financing for Development on 23–24 October 2007, and decided that the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus would be held in Doha, Qatar. It is scheduled to take place from 29 November to 3 December 2008.

II. The new landscape of FDI: opportunities and challenges

A. The global dimension

5. At the global level, FDI inflows reached an estimated $1.5 trillion in 2007, surpassing the previous record level of 2000 (fig. 1), with a rise in flows to all three major groups of economies – developed countries, developing countries, and South-East Europe and the Commonwealth of Independent States. The financial and credit crisis that started in the latter half of 2007 has not substantially affected FDI inflows to developing countries thus far. In fact, between 2002 and 2007, total FDI to developing and transition economies nearly tripled, from $180 billion to an estimated $518 billion. Indeed, 2007 witnessed the highest level of FDI inflows to these economies to date.

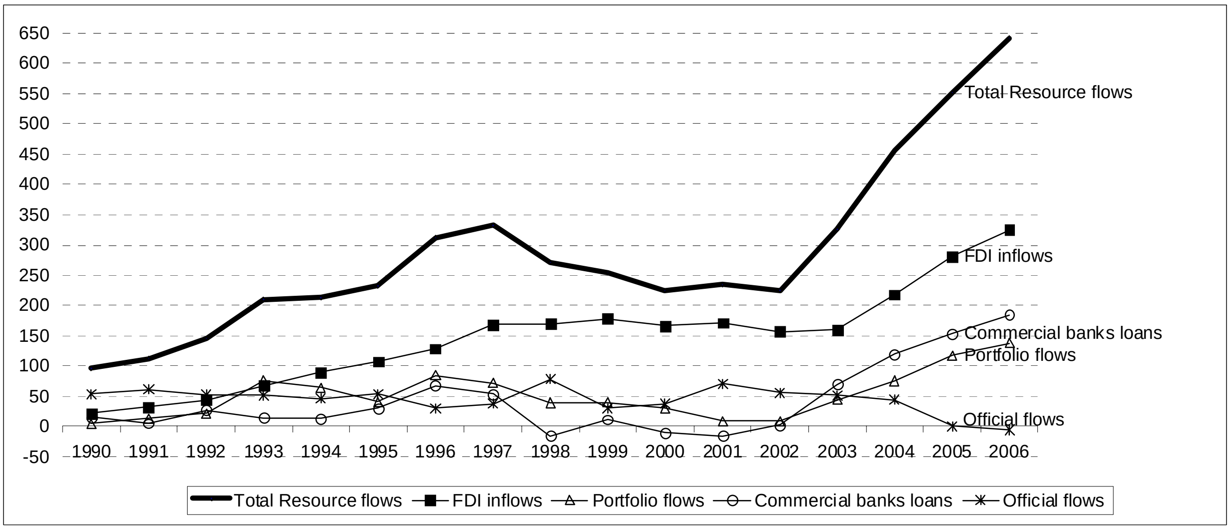
Figure 1. FDI inflows, global and by group of economies, 1980-2007
(Billions of dollars)



Source: UNCTAD, FDI/TNC database (www.unctad.org/fdi statistics) and own estimates.

6. The share of developing countries and economies in transition in global FDI flows reached 37 per cent in the period 2004–2006, compared to 27 per cent in the period 2001–2003. This may suggest that FDI has strengthened its role in capital formation in host economies and in international capital flows to those regions. Indeed, FDI flows accounted for 15 per cent of gross fixed capital formation in developing countries and economies in transition in 2006, compared with 10 per cent in the period 2001–2003; and FDI flows to those regions accounted for about half of all external private financial flows (FDI flows, portfolio flows and bank loans) in 2006 (fig. 2).

Figure 2. Total resource flows[a] to developing countries,[b] by type of flow, 1990-2006
(Billions of dollars)



Source: UNCTAD, based on World Bank 2007.

[a] Defined as net liability transactions or original maturity of greater than one year.

[b] The World Bank's classification on developing countries is used here. It differs from UNCTAD's classification in that it includes new EU member

7. However, FDI growth has been less impressive in the case of the poorest economies. Total FDI flows to the least developed countries (LDCs) were only $9.4 billion in 2006, just 40 per cent higher than in 2002. FDI flows remain concentrated by region and country. In 2006, 70 per cent of all flows to developing countries went to 12 destinations. Among the LDCs, there is also a strong concentration; the top three destinations (Sudan, Equatorial Guinea and Chad) accounted for 63 per cent of the inflows in 2006. In each of these three countries, the main point of attraction was the availability of natural resources, notably oil.

8. FDI plays a pervasive role in shaping the global production system. While the growth of international production slowed down during the FDI downturn period, foreign affiliates of transnational corporations (TNCs) produced one tenth of world GDP and accounted for one third of world exports in 2006 (UNCTAD 2007a, p. 9). Foreign affiliates raise funds for their investment in both domestic and international markets. The total funds used by TNCs for investment expenditures are estimated to be four times as large as FDI (UNCTAD 1997, pp. 25–27). Further research into how TNCs finance their investment abroad is needed in order to understand the actual role of TNC investments in the context of financing for development. Because of their long-term nature, funds for productive investment used by TNCs tend to be relatively stable.

B. Rising FDI from developing and transition economies

9. Traditionally, the primary sources of FDI worldwide have been enterprises from developed countries engaged in the production of goods and services. Recent years have witnessed a growing role of FDI from developing and transition economies. Their outward FDI surged from $53 billion in 2002 to $193 billion in 2006, or from 10 per cent to 15 per cent of global flows. Several developing countries that are armed with considerable amounts of foreign exchange are becoming sources of FDI. Some developing-country firms have emerged as global players (UNCTAD 2006a). In 2005, seven of the top 100 non-financial TNCs in the world originated from developing economies (UNCTAD 2007a).

10. The rise of FDI from emerging economies represents new sources of investment and appears to have benefited the low-income countries in particular (UNCTAD

2006a). Developing countries with the highest dependence on FDI from developing and transition economies include LDCs such as Bangladesh, Ethiopia, the Lao People's Democratic Republic, Myanmar and the United Republic of Tanzania. FDI from developing countries accounts for well over 40 per cent of the total inward FDI of a number of LDCs. For example, in Africa, South Africa is a particularly important source of FDI; it accounts for more than 50 per cent of all FDI inflows into Botswana, the Democratic Republic of the Congo, Lesotho, Malawi and Swaziland. Given the fact that market-seeking and efficiency-seeking considerations are important motives of FDI by firms from developing and transition economies, much of their investment is located in other developing countries. The impact of South-South FDI appears to be particularly pronounced in the poorest developing countries.

11. For host developing economies, South-South FDI broadens the range of potential sources of capital, technology and management skills to tap. This implies several potential advantages for the recipient economies (UNCTAD 2006a). Firstly, it may strengthen their bargaining positions as they have a greater number of potential investors to consider. Secondly, the motivations and competitive strengths of developing-country TNCs may diverge in several respects from those of TNCs from developed countries. For example, the technology and business models of developing-country TNCs may be closer to those used by firms in host developing countries, increasing the chances of linkages and technology absorption. Developing-country TNCs also tend to rely more on greenfield investment than on mergers and acquisitions (M&As). This means that their investments are more likely to have an immediate effect in improving production capacity in host developing countries (UNCTAD 2006a).

12. Outward FDI from developing countries provides a potential avenue for gains from economic cooperation among developing countries. But South-South FDI – like all FDI – can also give rise to concerns. One is that foreign TNCs might come to dominate a local market. There may also be fears of undue political influence, notably if the investing enterprise is State-owned. The political and social aspects of such TNCs' activities may similarly give rise to controversy, partly due the size of their operations. In host developing economies, such problems have sometimes been exacerbated by an absence of adequate regulatory frameworks and inequitable sharing of the economic benefits from inward FDI.

C. Selected sectoral trends in FDI

13. This section examines some emerging investment opportunities in host countries created by technological progress and liberalization as well as the rise of FDI from the South. Particular attention is given to the offshoring of services, FDI in extractive industries and FDI in infrastructure.

14. Increased tradability of services and competitive pressure have spurred offshoring or sourcing abroad of services. More and more services are being offshored by firms, both internally to foreign affiliates – giving rise to FDI – and externally to third-party providers abroad. Technological breakthroughs have enabled the production of services to be fragmented into smaller components that can be located internationally to take advantage of cost, quality or other considerations. Thus, more services can now be produced in one location and consumed in another.

15. Cost is one of the prime motivations for offshoring services. Thus, a wide range of service activities are now entering the exports of developing economies. Such business functions include simple low-value activities (e.g. data entry) or more sophisticated, high-value added activities (e.g. architectural design, financial analyses, research and development and software development). Many of these business functions cut across all sectors.

16. Obviously, not all corporate services and service functions will be offshored. Some functions cannot be digitized or separated from related activities. Regulations and legal requirements may also raise transactions costs and limit international trade in services. The lack of globally agreed privacy rules and treatment of intellectual property also limits the globalization of certain information technology-enabled services. Limits also exist in the capacity of international locations to host offshored service activities by TNCs. They include limited supply of appropriately educated workers, wage inflation and high levels of attrition, all giving rise to shortage risks, at least in the short run. TNCs, too, have different perceptions of risks and benefits, with some companies expressing a strong reluctance to offshore services. However, as increased competition forces enterprises to reduce costs, many choose to concentrate on their core competencies and offshore service functions to cheaper locations abroad.

17. Potential benefits for countries attracting services that are offshored include increased export earnings, job creation, higher wages and upgrading of skills (UNCTAD 2004). FDI related to the offshoring of services may also be desirable from a spillover perspective. Positive spillovers in terms of raising the competitiveness of human resources and improving the ICT infrastructure and business benefit all sectors of the economy, with most of the acquired skills being readily transferable to other parts of the economy. While offshoring is creating new FDI opportunities for developing countries, not all low-wage countries are benefiting from offshoring.

18. A second important change in the global landscape since the Monterrey Consensus was signed relates to commodity markets. The current commodity price boom has created a window of opportunity for some poor countries to raise additional finance for development through FDI in extractive industries. There has been a significant increase in FDI to countries rich in natural resources. Inflows to the major oil-exporting countries surged from $2 billion to $19 billion between 2002 and 2006. However, many resource-rich host countries are struggling to find the appropriate balance in the sharing of revenue from extractive activities between the host Governments and foreign investors (UNCTAD, 2007a).

19. Potentially the most important contribution from TNC participation in extractive industries may be increased government revenue. Countries that allow foreign investment in their extractive industries are seeking to strike the right bargain with the companies involved. This is particularly true for many of the world's poorest economies, for which various minerals are the prime source of export and government income. In response to the commodity price hike, many countries have recently taken steps to secure a greater share of the revenues from mineral extraction. Measures include nationalization, renegotiation of contracts and the introduction of various windfall taxes and royalties.

20. In order to translate increased government revenues into sustainable development gains, these revenues have to be managed and used in a way that promotes development objectives. In this context, there is a continued need for the strengthening of institutions, implementation of appropriate policies and enhanced transparency. To make the vast mineral resources located in some of the world's poorest countries a force for development, rather than a curse, a concerted effort by all stakeholders is necessary. A win-win situation can be achieved if various minerals are produced in the most efficient and environmentally-friendly manner possible, while at the same time revenues generated are deployed for poverty alleviation and accelerated development. It is important to make sure that this window of opportunity is not wasted.

21. Another important change in the sectoral pattern of FDI over the past quarter century has been the shift towards services (UNCTAD 2004). Since the early 1990s, this shift has also led to FDI inflows into infrastructure industries. FDI in

infrastructure has risen in both absolute and relative terms. In 2006, 30 per cent of cross-border M&A sales in the developing and transition economies were accounted for by such industries as electricity, gas and water services; construction; transport, storage and communications services; education services; and health and social services (UNCTAD 2007a, p. 23). As infrastructure development requires vast amounts of financing, it is almost impossible to meet such requirements from public or private national sources alone, in particular in developing countries. TNCs have increasingly been involved in infrastructure development through FDI (both greenfield investments and M&As) as well as through non-equity forms of participation (such as build-operate-transfer and other modalities). Private-public partnerships have become crucial in order to minimize the incidence of failure in the provision of infrastructure involving TNCs. Infrastructure TNCs from developing and transition economies have also emerged.

22. Many developing and transition economies have opened their infrastructure industries to foreign investment and improved the regulatory framework governing those industries. However, attracting private capital, in particular FDI, to satisfy the infrastructure needs of many developing countries would depend upon addressing concerns among foreign investors relating to regulatory risk. The 2008 *World Investment Report*, focusing on TNCs in infrastructure industries and development, will address these and other relevant issues.

III. Exploring the scope for synergies between FDI and ODA

23. Compared with other types of capital flows to developing economies, FDI has become the largest component since 1994; its share in all resource flows reached a peak of more than 70 per cent at the beginning of the 2000s (51 per cent in 2006) (fig. 2). But FDI is not a panacea. It cannot on its own solve or even significantly mitigate the underlying problems facing many developing countries. For that, first of all, domestic efforts and resources must be mobilized and reinforced by other external resources. Official financial flows that developing countries receive constitute an essential component of other external resource flows. For example, among the 50 LDCs, ODA still exceeds FDI inflows in 38 countries (UNCTAD 2006b, p. 2). The challenge is to make ODA and FDI complement each other.

24. Aggregate inflows of ODA (bilateral and multilateral) increased steadily for more than two decades to reach a level of $50 billion in 1991 – nearly twice the 1980 level (fig. 3). During the same period, FDI into developing countries rose more than fivefold to some $40 billion. From 1992, however, while FDI flows continued to rise, ODA decreased and, although it began to rise again in the late 1990s, they remained below their 1991 level until 2002 (fig. 3). The decrease in ODA during the 1990s was accompanied by a shift in its distribution towards countries with policies considered appropriate and by donor programmes to support debt relief initiatives for heavily indebted poor countries (World Bank 2002, p. 90; UNCTAD 2007b), as well as by efforts aimed at improving developing countries' policy environments in a direction conducive to growth and development.

25. There is agreement that aid would have to be increased significantly – to at least double its current level in real terms – in order to achieve the Millennium Development Goals.[3] ODA rose to a record level ($82 billion) in 2005, compared to $43 billion in 2002, when the Monterrey Consensus was signed (fig. 2). In 2006, however, it fell to $14 billion, mainly due to repayments of debt by many developing countries. In comparison, inflows of FDI to developing countries in 2006 were more

[3] For example, heads of State at the G8 meeting in Gleneagles in July 2005 agreed to double aid to Africa (an increase of $25 billion a year by 2010).

than twice their 2002 levels. Thus, the trends of ODA and FDI flows to developing countries have diverged in the past 15 years.

26. A similar picture applies to all developing regions (Africa, Latin America and the Caribbean, and Asia and Oceania) (table 1). There are, however, differences among them with respect to the relative importance of the two flows. In 2004–2006, the value of FDI inflows ranged from over 25 times the value of ODA inflows in Latin America and the Caribbean to 13 times the value of ODA inflows in Asia and Oceania, and three times the value of ODA inflows in Africa. Wide variations prevail among subregions as well – for instance, between South, East and South-East Asia, West Asia and Oceania in the Asia-Oceania region.

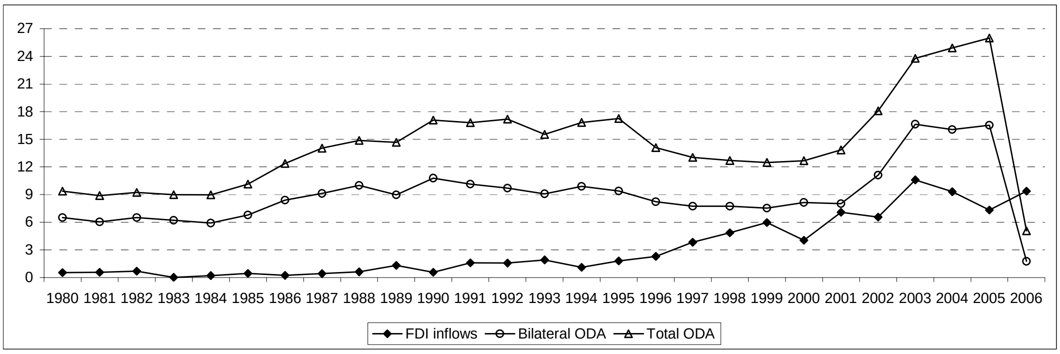
Table 1. Inward FDI flows and ODA flows, values and ratios by region, 1980-1982, 1990-1992, 2000-2002 and 2004-2006
(Billions of dollars, and ratio)

Region/economy	Millions of dollars								FDI/ODA ratio			
	Average 1980-1982		Average 1990-1992		Average 2000-2002		Average 2004-2006		Average	Average	Average	Average
	FDI	ODA	FDI	ODA	FDI	ODA	FDI	ODA	1980-1982	1990-1992	2000-2002	2004-2006
World	20.0	27.3	49.5	53.7	255.8	46.5	311.6	54.8	0.7	0.9	5.6	9.6
Developed economies	0.7	0.9	5.9	4.1	33.3	2.8	19.9	1.2	0.7	1.4	12.0	1 189.0
Developing economies	19.3	26.4	42.9	48.0	211.5	38.0	265.3	49.8	0.7	0.9	5.7	9.4
Africa	1.3	9.9	3.3	23.8	14.4	16.6	27.7	21.9	0.1	0.1	0.9	2.5
North Africa	0.3	3.3	1.2	7.1	4.3	2.6	14.5	3.2	0.1	0.2	1.7	6.3
Other Africa	1.0	6.6	2.1	16.7	10.1	14.1	13.2	18.8	0.2	0.1	0.7	1.3
Latin America and the Caribbean	7.4	2.5	12.6	5.0	76.8	4.7	79.8	4.2	2.9	2.5	16.8	25.2
South America	4.3	0.9	7.4	2.2	41.7	2.3	42.8	1.9	4.5	3.4	18.7	33.7
Central America	2.8	0.7	4.4	2.1	23.5	1.8	24.3	1.7	3.8	2.1	13.3	21.8
Caribbean	0.3	0.9	0.8	0.7	11.7	0.6	12.7	0.6	0.5	1.1	19.2	21.2
Asia and Oceania	10.5	13.9	27.0	19.1	120.2	16.7	157.8	23.6	0.8	1.4	7.3	12.9
Asia	10.4	13.0	26.6	17.8	120.0	15.4	157.4	22.7	0.8	1.5	7.9	13.3
West Asia	5.0	4.5	1.9	3.2	5.4	3.1	31.9	11.6	1.4	0.8	1.8	7.5
South, East and South-East Asia	5.4	8.6	24.7	14.5	114.6	12.4	125.4	11.1	0.6	1.7	9.4	17.8
East Asia	1.8	0.5	11.0	2.5	87.8	1.8	82.9	1.5	3.7	4.3	48.5	103.0
South Asia	0.2	5.1	0.6	6.7	6.0	5.6	13.2	6.0	0.0	0.1	1.1	4.4
South-East Asia	3.3	3.0	13.1	5.4	20.8	5.0	29.3	3.6	1.1	2.5	4.2	13.1
Oceania	0.1	0.9	0.5	1.3	0.2	1.3	0.5	0.9	0.2	0.4	0.1	1.1
South-East Europe and the CIS	0.0	- 0.0	0.7	1.6	11.1	5.6	26.4	3.9	- 0.8	0.3	2.0	8.8
Southeast Europe	0.0	- 0.0	0.1	0.6	3.8	2.1	8.3	1.7	- 0.8	0.2	1.8	5.4
CIS	-	-	0.5	1.0	7.2	3.5	18.1	2.2	..	2.9	2.1	13.8
Memorandum item:												
LDCs	0.6	8.5	1.2	16.7	5.9	14.8	8.7	18.7	0.1	0.1	0.4	0.8

Source: UNCTAD FDI/TNC database and OECD ODA/OA database (www.oecd.org/dataoecd/50/17/5037721.htm).
Note: Global and regional totals include only those countries for which both FDI inflows and total ODA are available.

27. Differences in the relative quantities of FDI and ODA received by regions largely reflect differences in the size and growth of FDI flows to individual countries and the concentration of FDI in a relatively small number of developing countries (located mainly in Asia and Latin America) that have higher incomes (per capita or total), or are exceptionally well-endowed with natural resources, particularly oil. They also reflect that ODA is concentrated in countries with low per capita incomes, most of which are in the Africa and the Asia-Oceania regions. In LDCs, ODA still exceeds FDI (except in 2006, the unusual year due to repayments of debts as noted above) (fig. 3).

Figure 3. FDI inflows and total and bilateral ODA to least developed countries, 1980-2006
(Billions of dollars)



Source: UNCTAD, based on FDI/TNC database (www.unctad.org/fdistatistics) and OECD ODA/OA database (www.oecd.org/dataoecd/50/17/5037721.htm).

28. The purpose of ODA, apart from addressing humanitarian needs, is to foster economic and social development in recipient countries. As such, ODA flows to a country can be expected to depend on the degree of the country's need for development assistance and its ability to utilize it effectively, rather than on its locational advantages for economic activity vis-à-vis other countries. The geographical allocation of ODA flows also reflects donor preferences, in terms of strategic, economic and political factors (Nunnenkamp et al. 2004; Berthelèmy 2005).

29. FDI, in contrast, is made by firms mainly motivated by the search for profits. Thus, a country's ability to attract FDI depends on its locational advantages compared with those of alternative production sites, be they in the form of large markets, low-cost resources, or cost advantages for efficient production. Advantages such as market size and cost competitiveness tend to improve with economic development and growth, leading to an increased role for FDI as countries develop and incomes rise.

30. Since the early 1990s, high and rising shares of ODA have been allocated to basic social services, education and health. Such activities attract little FDI in developing economies. Agriculture, which is no longer an important recipient of ODA (UNCTAD 2007b), similarly receives little FDI. In contrast, there has been a pronounced and continuing decline in the share of ODA going to manufacturing and communications. However, some infrastructure industries, especially those providing goods and services that offer limited profit prospects for private investors, continue to be important priorities for ODA overall: these include, for example, freshwater resources and land transport.

31. In 2005, over 30 per cent of ODA from the principal donor countries (the OECD's Development Assistance Committee (DAC) countries) was committed to education, health, population and other social infrastructure (OECD DAC 2007). Action relating to debt (including debt forgiveness) accounted for another 28 per cent. Economic infrastructure received about 11 per cent and production (agriculture and manufacturing) some 5 per cent. The rest was allocated to multisectoral activities, programme assistance, humanitarian aid and unspecified activities. In comparison, inward FDI stock in developing countries in 2005 was allocated to services (58 per cent), mainly producer but also consumer services – the most important ones being business activities, finance, trade, and transport, storage and communications – manufacturing (31 per cent) and the primary sector (9 per cent) (UNCTAD 2007a, p. 225).

32. Thus, ODA tends to focus much more than FDI on investments related to education, health, population and social infrastructure that are critical for human capital formation and human development. It also focuses, to a lesser extent, on investments in economic infrastructure. FDI, on the other hand, targets production in mining, manufacturing and, increasingly, producer and infrastructure services that are important inputs to other industries – especially telecommunications, trade, finance, and business services. In utilities (electricity, gas and water), and transport and storage, however, FDI and ODA co-exist, implying a potential for synergies.

IV. Policy issues for consideration

33. In the context of FDI, the development challenge is twofold: (1) how to channel more of global investment flows to developing countries, and especially those with the lowest levels of income; and (2) how to ensure that the investments that do come in are translated into sustainable development gains. This note has pointed to some positive signs with respect to the first challenge. For the second challenge to be met, an enabling business environment and appropriate institutions and policies are critical for countries to attract and absorb stable and longer-term capital for domestic and

international investment and to utilize it effectively in pursuit of development objectives. This final section of the note considers both the general policy framework for investment and policies specific to some of the FDI developments discussed above.

34. On the general policy front, developing countries continue to make and intensify efforts to put in place improved frameworks for FDI in their respective countries (UNCTAD 2007a). More countries across regions have introduced favourable national policy changes for both inward and outward FDI.

35. Recent years have also seen a proliferation of international investment agreements at the bilateral, regional and interregional levels. The universe of bilateral investment treaties and bilateral double taxation treaties has continued to expand, reaching 2,573 and 2,651, respectively, at the end of 2006 (UNCTAD 2007a, p. 6). Cooperation among developing countries in this area is intensifying. Furthermore, international investment rules are increasingly being adopted as part of other bilateral agreements and regional and interregional agreements that address issues relating to trade and investment transactions. The role of developing countries in international investment rule-making is growing along with the challenge of keeping the international framework coherent in order to use it more effectively to achieve the development objectives of countries.

36. As a follow-up to the Monterrey Consensus, there is a need to revisit recent proposals aimed at providing effective risk mitigation for FDI in low-income locations. For example, the Commonwealth secretariat has proposed the setting up of a dedicated and separate fund owned by existing international finance institutions but legally distinct from them. It would focus specifically on LDCs and other small and vulnerable economies with the purpose of assisting private investment in the production of goods and services in eligible States by offering domestic currency loans, quasi-equity investment capital and guarantees, as well as by retailing a specially simplified form of Multilateral Investment Guarantee Agency cover for political risk. Other suggestions include: increasing the creation of more effective regional insurance risk cover capacity with dedicated pools of capital and human resources, perhaps with special attention to the needs of LDCs; increasing the capacity of bilateral export credit agencies and official bilateral insurers to cover a wider range of non-commercial risks and to provide cover for those LDCs presently off cover; and the encouraging the development of public-private partnerships between official bilateral insurers and their nascent counterparts in developing countries.

37. **Garnering new sources of FDI**. Developing host countries need to consider how to leverage fully the expansion of FDI from developing and transition economies. In this context they should consider the full range of policies that can influence the behaviour of foreign affiliates and their interaction with the local business environment. In terms of addressing potential concerns and negative effects associated with such FDI, there is no major difference between the policies to apply in the case of FDI from traditional sources and those to apply in the case of FDI from developing and transition economies.

38. **Leveraging the growth in offshoring.** A growing number of countries are seeking actively to attract FDI in services by targeting specific activities, countries and investors. Investment promotion agencies often target FDI in export-oriented services, such as call centres, shared service centres and regional headquarter functions. General promotion measures, incentives and special zones (e.g. export processing zones) are the most widely used tools for FDI promotion in services (UNCTAD 2004). To attract offshored services, telecommunications and skills development are vital. Regulatory issues are also receiving increased attention especially in terms of data security and intellectual property protection. In order for export-oriented offshored services to stay and upgrade as wages rise and more

efficient competitors appear, Governments need policies to raise local capabilities and improve skills, institutions and infrastructure in line with changing realities. Investment promotion agencies can play a key role in helping investors meet new challenges through aftercare programmes and in raising awareness of the needs of the existing investor community through policy advocacy.

39. **Maximizing benefits from FDI in extractive industries.** Reaping greater economic gains from investment in extractive industries, and managing the considerable environmental, social and political risks associated with such projects require that many countries improve their institutions and policies. In low-income countries that possess significant natural resources, immediate attention should be paid to ensuring that they appropriate adequate shares of the revenues generated from the extraction of mineral resources, and that these revenues are managed and used in a way that promotes development.

40. However, to secure long-term gains a concerted effort is needed by all relevant stakeholders, including TNCs and their home countries. Home countries should promote the responsible behaviour of their TNCs, especially when they own the investing companies. Home countries can also help recipient countries build efficient policy and governance by providing financial and technical assistance.[4] In some host countries, human capital and technical support may be the most needed contributions. The role of TNCs, in turn, is to contribute to more efficient production while respecting the laws of the host country. The Monterrey Consensus urges businesses to take into account the broader development dimensions of their undertakings. When the extraction takes place in weakly governed or authoritarian States, companies need to consider carefully the implications of such investments and, if they do invest, to abide by internationally acceptable standards. In the case of extractive industries, a number of noteworthy multi-stakeholder initiatives have been launched in recent years. Initiatives such as the Kimberley Process and the Extractive Industries Transparency Initiative should be fully endorsed and supported. Their impact will depend on universal compliance. It is important that all TNCs behave responsibly when investing abroad, be they large or small, from developed or developing countries, and private or State-owned.

41. Low-income countries without large endowments of natural resources often have little to offer foreign investors. For these countries, FDI should not be expected to be a prime source of development finance, at least not initially, although it may be an important complement to others. They have to explore ways to promote the development of created assets, such as human resources domestic productive capabilities and entrepreneurship. Active assistance aimed at building infrastructure, strengthening basic education and health care should be given priority. The prime objective should be to support a process through which local companies can become better equipped to participate in the international economy by way of exports or interaction with foreign affiliates that invest in their economy. It may also be necessary to explore new and innovative ways to combine different forms of development finance, including ODA, loans and FDI.

42. **Providing better public services through improving infrastructure.** While involving foreign companies in infrastructure services, including through public-private-partnerships, can bring important benefits in terms of new capital and more and better services, it also entails costs. FDI in infrastructure raises a special challenge in terms of regulation and governance. Governments therefore need to establish clear objectives for involving TNCs in infrastructure. It is important for the State to strike a

[4] For example, through its Oil for Development Initiative, Norway offers short- and long-term assistance to oil-rich developing countries. The collaboration between the United Nations Economic Commission for Africa and the African Development Bank is also noteworthy in this context.

balance between budgetary and other considerations, such as the efficient and competitive provision of services or affordable prices for the poor or people living in sparsely populated areas. FDI in infrastructure can present specific problems. Investor counterparts are often legally and financially powerful private institutions. Specialized agencies can help carry out a competitive selection process, provide information to investors, as well as maintain independence from governments and vested interests in State-owned enterprises.

43. **Exploiting ODA-FDI synergies.** Despite significant growth in FDI flows to developing countries, many countries, especially LDCs, receive marginal flows of FDI and depend significantly on ODA for financing development. It is important for countries to recognize the synergies that can exist between ODA and FDI and harness them for attracting more FDI and more associated benefits. The effective use of ODA for building human-resource capabilities, developing infrastructure and enhancing domestic enterprise capabilities in recipient countries can create conditions conducive to attracting more diversified FDI with enhanced host-country benefits.

44. In the light of the above discussion, delegates and experts may wish to consider the following questions:

(a) How can the role of FDI in financing development be better harnessed?

(b) What does the rise of FDI from developing and transition economies mean for enhancing access to development finance?

(c) How does the current commodity price boom and associated investments influence the chances of financing development in countries that are rich in natural resources and in countries that lack such resources?

(d) How can synergies between different forms of development finance, notably ODA and FDI, be strengthened? For example, what is the optimal mix between these forms of finance in different infrastructure projects?

(e) What innovative forms of financing infrastructure development should be explored?

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