REVIEW ARTICLE

World Investment Report 1996: Investment, Trade and International Policy Arrangements

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Most measures suggest that foreign direct investment (FDI) and the associated international production deserve at least as much attention as international trade. Yet the former receive far less attention, whether it is in the quality of the data, international policy arrangements, or the outdated chapter on international investment in most of the standard texts on international economics. The annual *World Investment Review* (WIR) produced by UNCTAD has become the single most important source book covering data trends, policy questions and particular analytical themes. The past five volumes examined, in sequence, the role of the United States, the European Community and Japan (the Triad), which are the homes for most transnational corporations (TNCs); the impact of FDI on host countries; the theme of integrated international production networks; the effects of such production on employment, the workplace, human capital and labour relations; and the implications of all of this for the competitiveness of firms and the performance of home and host countries.

The *World Investment Report* for 1996 is a logical next step in this series. It develops at some length the relationship between foreign trade and FDI and then focuses on the issue of international policies for FDI which might begin to match those for trade, or, indeed, simply keep up with the spread of international production. As in the past, the volume was produced by a divisional team led by Karl P. Sauvant, which drew also on a range of experts both within and outside the United Nations, with John H. Dunning acting as Senior Economic Adviser. This review will summarize briefly each of the three parts on data trends, FDI and trade and the question of a

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multilateral agreement, while raising also some issues that might be addressed in later volumes.

Trends in foreign direct investment and data improvement

Part one spells out overall and regional trends in FDI while also highlighting several issues. Not only did FDI flows reach unprecedented levels in 1995, but rates of increase for flows and stocks exceeded those for trade and GDP in the early 1990s as they did in the late 1980s. FDI became the largest single item in net private capital flows to developing countries, and was the reason these flows rose in 1994 and 1995.[1] How rapidly the world of TNCs is changing may be gauged, among other ways, by the survey of the largest TNCs. A Canadian publishing and printing TNC, The Thompson Corporation, ranks first judging by a composite index of foreign assets, foreign sales and foreign employment, although only sixtieth by the first of these alone.

The developed countries accounted for 73 per cent and 92 per cent of the world's inward and outward stock in 1995, with the United States continuing to act as both the largest home and host country in terms of flows. Once again China was the single largest recipient of FDI flows in the developing countries, receiving 40 per cent of the total. It is important to add that inflows to other developing countries rose by 16 per cent and 10 per cent in 1993 and 1994, respectively. Investment inflows to some Latin American countries are particularly volatile, reflecting in part the differential pace of privatization. Central and Eastern Europe received 5 per cent of FDI global inflows in 1995 compared with 1 per cent in 1991. Fully 61 per cent of inflows to sub-Saharan Africa in 1993-1995 went to a single oil-producing country, Nigeria, and 48 per cent of flows to North Africa in the same period went to Egypt.

These few highlights cannot do justice to the rich load of data produced, updated and improved each year, as evident in the text and the

[1] The importance of FDI in capital flows is sometimes overlooked in research on this topic. For example, Calvo, Leiderman and Reinhardt (1996), purporting to analyse the motives for and macroeconomic effects of the "total balance on capital account" for Latin America and Asia, contains only a few passing references to FDI.

appendices. This material is based largely on IMF sources, UNCTAD's own extensive database and OECD, as well as some special studies. One should note particularly the other special sections other than those above such as the detailed analysis of international mergers and acquisitions, that on infrastructure FDI, and the analysis of the quality of the data on inflows to China as well as the question whether these flows will continue to rise. The section on China warrants a chapter in itself, given the size of the flows and the problems involved in interpreting both the policies and the data.

There are several ways in which the data should be improved. First, the data on both stocks and flows are incomplete, despite efforts by UNCTAD to fill in some of the missing pieces. The lack of historic detail on bilateral flows for all but a few countries has been a particular problem. The quality of the data also leaves much to be desired in terms of the differences in methodologies and coverage, valuation and so on. This point has been recognized for some time, and some of the major consequences for analytical purposes have been noted (for example, Kinniburgh and Ribeiro, 1986; Gray and Rugman, 1994). Efforts by OECD and other organizations to improve the data have met only moderate success. The negative consequences for both analysis and policy will be noted in the following sections.

Second, the data on cooperative forms of international activity are far inferior to those on both FDI and trade. While particular topics such as supplier links, licensing and franchising have been discussed briefly in earlier volumes, there is no attempt to present in each issue a systematic global and regional perspective on trends. There are many difficulties in developing such series. Apart from partial series on royalties and the like, one must rely in the main on a variety of private sources with different definitions and coverage. These studies, moreover, cover the developed countries far better than developing countries, and are especially weak in areas of the world such as much of Asia where informal trust-based relationships are common. Perhaps worst of all, almost all studies give numbers of agreements only, so that one has no sense of their overall importance relative to trade and FDI. Yet a number of excellent overall studies exist, along with many good sectoral studies (see Safarian 1996 for a listing). It is time to explore systematically the size and role of international joint ventures, research agreements, various technology-exchange arrangements, customer-supplier relations and all the other inter-firm agreements which are neither FDI nor arm's length sales. Since a TNC is involved in most such international agreements, one can argue that the lack of suitable data on them understates the importance of TNCs. Judging by the many research studies it

has conducted on aspects of these agreements in the past, UNCTAD is well placed to produce such an overall study and to update and improve it regularly.

Finally, a small quibble on the series on the share of FDI flows to grows fixed capital formation, a series which appears by country in each *World Investment Report*. This is a useful supplement to other measures of the relative role of FDI, with the advantage of broad coverage by countries over time. Some note should be taken of the problems which arise in linking financial series (equity investment, reinvested earnings, intra-company loans) with capital formation (Carty and Safarian, 1954). Those problems go well beyond the uneven representation of the different components of FDI, which is noted on p. 222.

Foreign direct investment and trade

This part examines the linkages between trade and FDI and the implications for national economies. Chapter 3 outlines the traditional sequential relationships between these variables in manufacturing, natural resources, services and where the firm produces in more than one of these sectors. This chapter would have been improved by reference to the results in two of the best studies of this topic, namely Hufbauer and Adler (1968) and Reddaway and Associates (1968). It is emphasized that the linear sequence of the product-cycle model, with FDI replacing trade, is qualified even for manufactures, and more so for the other sectors.

Chapter 4 goes on to explore the trade and FDI relationship in a world where many technological and policy-related barriers to the movement of products and factors have declined and where international production for a regional or global market is well established and growing. Some of the consequences are noted, based in part on research in earlier volumes: the relative importance of the determinants of FDI location has changed, with the size of national markets being less important and such factors as cost differences, skills availability, quality of infrastructure and ease of doing business becoming more important. Transnational corporations have a greater opportunity to integrate their production facilities into integrated systems, regionally or globally, with the consequent decline in the importance of long-standing broadly-based subsidiaries aimed at national markets. The sequential process implied in earlier views on the relation between trade and

FDI becomes blurred. So does the distinction between headquarters and production functions, with any value-adding activity locatable, in principle, wherever its expected contribution to the TNC is largest. Intra-firm trade soars.

WIR 96 draws several national policy implications from its analysis of the above trends. Specifically, trade and FDI are now so intertwined and, in general, complementary that national policies towards them need to be coordinated more fully. Given the differences among countries, however, such coordination does not imply any standard policy package. Broadly speaking, the advice is to use TNC capabilities so as to enhance the comparative advantage of particular locations. This involves the production of specialized products and components, moving to more advanced technologies and perhaps undertaking some centralized functional activities for TNCs such as data processing. More dynamic effects are feasible where local capabilities or potential allow subsidiaries to upgrade technology and to innovate, within the TNC network. *WIR 96* sees gains for countries that are prepared to participate in the ''finer and wider'' division of labour involved in the new world of TNCs. It also warns that most developing countries have limited opportunities to attract traditional FDI, much less the newer kind, given especially their low investments in human capital and infrastructure, and also that the gains from this extended specialization can impose serious adjustment problems for some groups in both developed and developing countries. These sections on policy should be read within the context of earlier detailed studies on TNCs, employment and competitiveness as developed in *WIR 94* and *WIR 95* respectively.

One of the more welcome innovations in *WIR 96* is the annex to part two dealing with the integration of the theories of FDI and trade. One of its conclusions is surely correct—that there is a need for closer understanding of each other's research by those specializing in international micro and macroeconomic theory and those working on international business. One need only look at who is being cited in articles in the standard journals of each group to realize how big this gap remains. One must also agree with what is well summarized in this annex, namely that international trade theory has made long strides since the early 1980s in incorporating TNCs. Yet the summary leaves mixed feelings, perhaps because of its brevity. On the one hand, it does not acknowledge how far trade theory has gone in incorporating economic growth, which is critical to the understanding of the contribution of TNCs (see particularly Grossman and Helpman, 1992). On the other hand, as *WIR* points out, the two branches of the new trade theory

which encompass vertical and horizontal FDI are constrained by assumptions long since modified or even abandoned in the empirical literature on international business. One thinks, for example, of the assumption for horizontal FDI that headquarters activities are concentrated in the parent firm in order to reap scale economies, in contrast to studies which show significant decentralization of such activities for some countries and sectors (contrast, for example, Markusen, 1995 and Pearce, 1990). One way to move further in integrating theories of FDI and trade is to improve the data available for testing theory, as noted further in the next section.

Towards a multilateral agreement on foreign direct investment?

Part three of the study proceeds logically from the discussion of FDI and trade linkages to explore whether (and in what ways) an international framework for FDI is needed and how it should be related to that already available for trade. In a valuable set of tables it spells out the nature of the many existing bilateral, regional and multilateral agreements. These arrangements are not new; but there has been a considerable expansion of bilateral and regional investment agreements in recent years: some FDI-related issues were covered in the Uruguay Round, negotiations on a Multilateral Agreement on Investment (MAI) are under way in OECD, and some of the issues are under discussion in APEC. Some of the conclusions and lessons from this review are: there is now a great range of agreements, but this leaves one some distance from a "coherent and complete international FDI framework"; some investment integration agreements, such as in the European Union and the North-American Free Trade Agreement, have moved ahead of the others; the policies and accords on investment have reflected the national priorities at given periods of time; there is widespread recognition of the major issues that need to be considered, but progress in reaching agreement has been quite gradual; and it is important to design international instruments that allow for differences in economic development and in national approaches to FDI, without being simply a set of principles without obligations.

Research on international rules for FDI has proliferated in pace with agreements and negotiations (for example, Sauvé and Schwanen, eds., 1996). The approach of *WIR 96* in its concluding chapter is to concentrate

on defining the broad policy approaches, the key issues and to take a brief look at recent international initiatives.

The first point examined is the arguments for two basic approaches, that of improving current arrangements and that of attempting to secure a comprehensive framework agreement. The main reason for favouring the former is that it seems to be working: both trade and investment are growing rapidly, and different groups of countries can have the degree of policy integration on investment which they prefer. The main reason in favour of the latter approach is that it would yield a more predictable and transparent setting within which trade and FDI might grow even more. The discussion here has some valuable specific dimensions, such as the analysis of what business means by "strong" rules and the discussion of objectives such as market contestability, modal neutrality and policy coherence.

The second and largest section identifies and outlines the key issues requiring consideration as international arrangements develop. This discussion is organized under four topics. The first concerns investment measures that affect the entry and operation of FDI. The second topic is the application of certain positive standards of treatment to FDI, particularly national treatment and "fair and equitable treatment." Thirdly, the report considers measures directed to a variety of concerns such as the setting of appropriate standards of behaviour and ensuring that markets function. Included here is a discussion of restrictive business practices, transfer prices, transfer of technology, employment, environment, and illicit payments. Finally, the focus is on the reduction or elimination of non-business risk through investment protection and dispute settlement. The final section of the chapter outlines the implications of the OECD discussions of MAI and of initiatives in the World Trade Organization.

One hopes that UNCTAD will take this exploratory discussion much further, given the importance and currency of the issues. With that in mind, one can suggest three topics which could be developed more fully at the next stage, namely, the theory of public policy, the issue of deeper integration, and the framework of data and of policy transparency which are critical both for policy analysis and effective implementation. The first point is simply that a more comprehensive and explicit view should be developed of why governments do what they do. Without this, the policy approaches and instrument designs are less likely to be workable or even positive in welfare terms. The most explicit reference to government objectives suggests that economic growth and development are "overarching", and adds that such

objectives include security and social welfare (p. 164). There is only passing and limited reference elsewhere to what has been frequently demonstrated in the literature on both trade and FDI, and that is the considerable capacity of interest groups, both economic and political, to use the State's powers for income distribution in ways unlikely to increase social welfare (for example, Safarian, 1993, chaps. 2 and 10). It is necessary, in other words, to be more explicit and comprehensive about what one means in welfare terms when imperfect governments address imperfect markets and firms, even while recognizing that the prescriptions come from imperfect social science.

Two examples will suffice. *WIR 96* makes much of the fact that there was a substantial shift in the 1980s towards liberalizing and promoting FDI, as well as away from import substitution towards export promotion, in part because of a greater appreciation of the opportunities offered by FDI to link up with international networks (for example, pp. 155-156). This is quite clearly the case. It is also true that substantial restrictions still remain on FDI, in both developed and developing countries. Moreover, as generalized restrictions have diminished, many governments have resorted to selective industry or firm-specific policies through increased use of fiscal incentives and non-tariff barriers, that is, to managed internationalism. One interpretation of this is that governments are learning to live with TNCs—their own and everybody else's—but not necessarily to trust their investment and related decisions. One cannot be certain, then, that policy on FDI (and on trade, deregulation and privatization) will proceed in a linear liberalizing fashion from here on, rather than in reversible waves (Safarian, 1993, chap. 12).

The second example of the importance of a theory of public policy is in the discussion on the desirability of some types of restriction on FDI for development purposes. A case is made in developing countries for infant-industry protection of local producers from FDI, analogous to the case for trade protection. *WIR 1996* is careful to note that this type of exception should be temporary and should avoid the development of costly, inefficient production structures, and acknowledges that the experience in this respect is mixed (pp. 175, 184). This is slippery ground. It would have been more convincing to go on to explain more precisely the circumstances under which infant-industry protection in terms of trade is likely to succeed in welfare terms, and to go on to note the further circumstances necessary to extend the argument to FDI. The way in which many governments have embraced the limited case for strategic trade and investment theory, disregarding many of the policy and economic conditions necessary for

successful implementation, should be warning enough of the need for a full and explicit theory of public policy and close attention to instrument design. All of this, one should add, is **not** a case against policies aimed at promoting growth and development, as appropriate to particular countries. *WIR 96* is sensitive to this issue since it notes (p. 178) that development-oriented policies are not necessarily discriminatory or directly interventionist. In general, one would hope that further discussion of the issues outlined in this part of the report will be accompanied by more analysis of the welfare effects of different kinds of policy, both national and multilateral.

The second and closely-related topic which needs more analysis is the issue of deeper integration. Many of the issues outlined by *WIR* could go deeply, indeed, into constraining national policy preferences for development and growth, in the direction either of harmonizing particular policies, requiring resort to other means, or reducing policy effectiveness. The prior question is whether these constraints are all really necessary. Deep integration has taken on a life of its own, but it is still not too late to raise this question. On any particular issue one should be asking just how large are the overall welfare costs of **not** developing a common approach. That, alone, may settle the issue. What are the expected gains, particularly in terms of development and growth? In what sense is policy autonomy and choice limited thereby for national governments? Is there an alternative which can limit the policy and other costs? And how do you design policies flexible enough to meet the legitimate policy needs of countries of different kinds, without leaving the entire process open to capture by special interests, both economic and political? If one cannot answer such questions even approximately, the way is open for simple rent-seeking power plays and an even more complex patchwork of arrangements with doubtful welfare outcomes. *WIR 96*, of course, is not insensitive to this set of questions, and is particularly forceful in arguing for consistency of any arrangements with development needs. A good case is also made for something more than the present jumble of policies. While careful not to prejudge any particular approach, a useful contribution is made in identifying key issues to be considered and the types of arrangements likely to suit a diverse set of countries.

The third topic warranting further study follows on some of the suggestions earlier in this review. It is important to find some minimum approach which is widely acceptable if multilateral arrangements are to develop further. One modest proposal could have significant effects on the entire set of issues under discussion. That is simply to improve the data on

FDI stocks and flows and, simultaneously, the transparency of policies. In analytic terms, FDI is still the junior partner in the trade and FDI linkages described earlier. That is partly due to the inability to test theory and policy on FDI in the ways possible with the wealth of data on trade.[2] The attempt to improve transparency of policies is much more than a listing of what exists in some consistent and meaningful way, difficult as that will be in practice. The effort should be directed in part to improving our capacity to answer some of the welfare questions raised earlier, and hence contributing to the negotiations on key issues. One parallel is the way in which the complex area of non-tariff barriers was handled, first by measuring them in tariff equivalents then by placing these into multilateral negotiations on trade.[3] The parallel is imperfect, since policy on FDI is often more complex, opaque and deeply integrated with a country's objectives than is policy on trade. But that is just another way of recognizing that multilateral negotiations on FDI will require at least as much expertise, patience and flexibility as those on trade.

This review has been in part about what is not in the study. This should not detract from the importance and thoroughness of what has been analysed in *WIR 96*, a report which maintains the high standards and relevance one has come to expect in this series. ■

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[2] For example, the widely-quoted study by Coe and Helpman (1995) and subsequent extensions uses trade as the channel for measuring international technological spillovers among developed countries. Bilateral data on FDI which are necessary to measure spillovers through this channel are simply not available for most countries. Hejazi and Safarian (1996) use the Coe and Helpman methodology and data to assess FDI as a channel, using only data on trade and FDI for the United States. They find that FDI is a more important channel than trade. One should add that a working group in APEC, under the leadership of the Australian statistical agency, is attempting to improve FDI data in that region.

[3] A similar point has been developed by Guisinger (1996) who argues that the absence of a credible measure of the restrictiveness of investment regimes and, consequently, of the macroeconomic effects of liberalization, partly explains the reservations of many developing countries on such regimes. By contrast he notes how the concept of effective protection improved the study of trade policy.

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