

# **Maximizing Synergies between Foreign Direct Investment and Domestic Investment for Development: Enhancing Productive Capacities**

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## **INTRODUCTION BY JAMES ZHAN**

**[Show Slide 1]** It is a pleasure for me to introduce to you the issue of development implications of synergies between foreign direct investment (FDI) and domestic investment, which has been chosen as a topic for the second session of multiyear expert meeting on “Investment for development”. Countries require capital for development and economic growth. As domestic investment levels are low, especially in least developed countries (LDCs), there is a need to harness FDI as a complement to the development finance process. Before focusing on specific industries such as agriculture and climate change I would like to mention briefly the relation between domestic and foreign direct investment from the global perspective

**[Show Slide 2]** The long-run relationship between capital formation, the capital stock and economic growth is of paramount importance to the development process. The relationship between the growth of an economy and FDI is much debated in the literature. The empirical evidence suggests a positive role for FDI in generating economic growth, with the relationship between foreign and domestic investments more relevant and important in developing countries than in developed countries. However, the fact that FDI constitutes at most 15% share of gross capital formation at the global level implies that much of economic growth is linked with domestic investment, even if foreign affiliates produce more per dollar of investment than local counterparts.

**[Show Slide 3]** The existence of foreign affiliates may affect domestic firms and, in some cases, may exclude them from markets. As a whole, if foreign affiliates cause a reduction of investment by local firms through crowding-out effects, host countries may lose opportunities of longer-term growth by their own firms. There is the need for a balance between the level of investment by foreign affiliates and that by domestic firms. The mechanisms for positive, neutral or negative impacts by foreign-owned capital upon domestic firms are usually presented as "crowding-in", "neutral" and "crowding-out" effects. Differences in the effects of FDI on domestic investment among countries and regions imply that national development strategies and

investment policies such as policies strengthening linkages between foreign affiliates and domestic firms should be coordinated to ensure the maximizing of synergies between FDI and domestic investment.

**[Show Slide 4]** For any economy, investments that meet the objectives of development better are more welcome than other investments, no matter where these investments come from, domestic or foreign firms. Although it is difficult to determine which firms perform better from the development perspective as the results differ in depending on the context and assumptions made, data on foreign affiliates of United States TNCs indicate that foreign affiliates produce more value added than domestic firms (represented as all firms) in certain regions and countries.

**[Show Slide 5]** As foreign affiliates not only receive and use funds from their parent or affiliated firms, but also secure them from local sources such as commercial banks and financial markets, domestic firms may find availability of such sources of funds reduced. The current financial and economic crisis has reduced further the access to new credits for both domestic and foreign firms. Data on local financing by United States foreign affiliates, as well as Japanese ones (which are not on the table on the slide), show that half of their external funds are indeed locally sourced in both developed and developing host regions. Policymakers should seek to ensure a fair availability of finance to domestic as well as foreign firms.

**[Show Slide 6]** I would like to mention the importance of public-private partnerships (PPPs) in strengthening foreign and domestic investment relationship in infrastructure, without going into details as infrastructure has already been considered at the first session of the Investment, Enterprise and Development Commission in 2009. As you know infrastructure industries have a number of characteristics which make their activities operationally difficult, and therefore TNCs' role in building the capabilities of domestic firms can be crucial. In order to entertain both public and private interests in infrastructure projects, among the various forms of public-private partnerships (PPP), the concession of a public service to a private company through management contracts or joint operating schemes has emerged.

Experience has proved that PPPs have substantially helped meet local development needs, especially through the transfer of complex technologies and expertise to the local economy and enterprises.

**To conclude** there a number of questions that experts have to consider such as a) which policy options can be used to ensure that FDI does not lead to the crowding-out of domestic investment? b) which policy alternatives are considered to arrive at the best possible balance between foreign and domestic investment in order for a country to achieve a long run, sustainable and inclusive growth c) how can the relationship between foreign and domestic investment in infrastructure – such as public-private partnerships (PPPs) – meet local development needs?

**[Show Slide 7]** While the above discussion has examined potential competition between foreign and local firms, in practice there are several situations under which these types of firms work together to exploit their comparative advantages and achieve mutually beneficial outcomes wherein such cases synergies between domestic and foreign investments are enhanced. I will introduce to you the issue of interaction between domestic and foreign investment in agriculture and climate change which have been chosen as a prominent example for the overall theme of this Expert Meeting. In both two cases foreign and local firms work together to exploit their respective comparative advantages and achieve mutually beneficial outcomes through interaction.

**[Show Slide 8]** In the agriculture sector, domestic investment is predominant, but FDI can play a significant complementary role, in particular with regard to the production of high-value-added crops. In addition, the recent renewed interest by some food-importing countries in FDI in staple food production provides additional opportunities for expanding agricultural investment in developing countries. In agriculture, interactions between domestic and foreign investors can take on many forms; and we will devote the afternoon session today and the morning session tomorrow to discuss them. This afternoon we will explore the potential of creation and enhancement of synergies between domestic and foreign investment in agriculture; and tomorrow morning we will take up the issues related to contract farming.

Please first allow me to make a few introductory remarks on trends in global FDI and other forms of TNC participation in agricultural production. UNCTAD Secretariat has issued several notes and publications on this. The World Investment Report 2009 launched in September last year gives you comprehensive information:

First, at the global level, FDI flows in agricultural production tripled to \$3 billion annually between 1990 and 2007, driven by the food import needs of populous emerging markets, growing demand for biofuel production, and land and water shortages in emerging economies. **[Show Slide 9]** In many low-income countries, agriculture accounts for a relatively large share of FDI inflows; and the latter are significant in capital formation in the sector. But, overall, worldwide FDI stock in agriculture is still very low, amounting to only \$32 billion in 2007.

**[Show Slide 10]** Second, TNCs participate in agricultural production not only through FDI, but also via non-equity modes of entry. In particular, contract farming activities of TNCs are spread worldwide and become increasingly significant. They cover over 110 developing and transition economies, span a wide range of commodities and, in some cases, account for a high share of agricultural output. This is true, for instance, in the production of soya bean in Brazil, cotton in Viet Nam and tea and sugar in Kenya.

**[Show Slide 11]** Now let me turn to the development impact of foreign investment in the agricultural sector. The involvement of TNCs has promoted the commercialization and modernization of agriculture in many cases; and there is considerable potential for more TNC participation in the future. In particular, their contractual relationships with local farmers can bring major beneficial effects: they provide inputs and transfer skills to a large number of small farmers; ease their financial and technological constraints; and link them up to global markets. All these are conducive to promoting sustainable and pro-poor agricultural development and alleviating rural poverty. That is why we devote the whole morning session of tomorrow's meeting to contract farming, in order to explore what can be done to promote contract farming arrangements and how to make them mutually beneficial for foreign companies and local farmers.

Existing evidence also shows some negative consequences of TNC participation, such as concerns related to "land grab", the marginalization of local farmers and environmental degradation. What are the net effects? Our research shows that the actual impacts and implications vary enormously across countries and types of agricultural goods. They are influenced by a range of factors. One of the most important factors is: whether there are effective, positive interactions between foreign investors and local entities, especially farmers.

**[Show Slide 12]** "Best practice" examples from various regions and countries show that these interactions can take place through, for instance, joint agricultural production, contract farming, as well as public-private partnerships in R&D and infrastructure.

I would like to discuss with you the development implications of these interactions, and the policy options to make such interactions instrumental for sustainable agricultural and rural development. I look forward to our deliberation at this meeting and I am confident that it will yield many innovative and inspiring ideas.

**[Show Slide 13]** The fight against **global climate change** has risen on political agendas worldwide. This was attested to by the presence of more than a hundred Heads of State at the UNFCCC's climate change conference in Copenhagen last December. At this conference, a greater stress on the role of private sector actors in the necessary efforts to combat climate change, and especially TNCs, became apparent.

The rationale behind this is the observation that, while TNCs have contributed to the problem in the first place, they must and can play a major role in providing the solutions due to their innovative capacities and global reach. This might be especially important in diffusing the relevant technologies and practices for climate change mitigation and adaptation to developing countries, especially as their economic development inevitably markedly increases their carbon greenhouse gas (GHG) emissions. However, there is currently little known about the nature of the nexus between climate change, FDI and development.

What we do know is that overall estimated investment needs are huge, both in the short and the long term. However, there are two important observations to make, one is that this strongly differs by industry [Slide 14] and second that TNCs are more active in some industries than others. Therefore some more concrete industry focus is warranted. For example, one industry requiring a closer look is the power sector and, within this, renewable energies - where TNCs are highly significant - is an important alternative to fossil fuel based energy, which is responsible for a great part of global GHG emissions.

[Show Slide 15] Global growth of investment into renewable energy has been strong over the last few years. Excluding large hydro projects, approximately 40GW of renewable energy power generation capacity was installed globally in 2008, accounting for 25% of new nameplate capacity addition (amount of electricity that the generator is designed to produce) and 23% of new power generation increase. In total, renewable power as percentage of global power capacity increased from 3.9% to 6.2% and percentage of global power generation from 2.9% to 4.4% between 2002 to 2008.

[Show Slide 16] There are six main technologies (in renewables): in decreasing order of investment to date, they are wind, solar, biofuels, biomass & waste-to-energy, marine & small-hydro and geothermal energy. Based on the number of FDI projects in these renewable energy industries identified by UNCTAD, in developing and transition regions, foreign investment into the different renewable energy sectors has shown a strong increase in the last few years.

In particular, investments into wind and solar projects showed a particularly strong growth:

- *Wind* turbines for electricity production have been the fastest-growing energy technology, which has led to rapid industrial development and increased experience in terms of operation and maintenance.
- *Solar* power generation has recently been growing enormously due to improved policy environments.

**[Show Slide 17]**

- Although foreign investments into renewable energy projects target all developing regions, the majority of deals take place in South, East and South-East Asia. The second region in terms of foreign investment projects is Latin America and Caribbean. Within these regions the majority of the deals take place in the emerging markets, and in particular in China, India and Brazil.
- Investors target different technologies in each region; wind and solar projects are typically more targeted in South, East and South-East Asia, and biofuels and hydro power in Latin America and Caribbean.

**[Show Slide 18]**

1. TNCs invest in different parts of the value chain, depending on industry and technology, e.g.:
  - The construction and operation of energy generation facilities, for instance wind or solar parks;
  - Manufacturing of components, for instance solar panels or wind turbines;
  - Services, for instance maintenance or setting up of sales offices;
  - And research and development, for example expanding global R&D networks
2. All of these areas could present opportunities for linkages between foreign and domestic investors in host countries.
3. However, most deals take place in the first two areas: power generation and manufacturing.
4. Foreign investments are to a large extent, and perhaps more than in other sectors, driven by the policies in the host market.

**[Show Slide 19]**

1. The question for policy makers in host countries is how to promote linkages between foreign investors and domestic private and public investors.
2. Policy regimes will be determined by, among others, country differences, sector differences and the different stages of technological maturity.
3. Policies to promote linkages are therefore also likely to differ between host countries.
4. However, there are a number of questions that all policy makers may want to consider. These include:
  - To what extent should host countries create conducive conditions and provide incentives to TNCs to locate their technology-intensive low-carbon activities there?

- What are company motivations for undertaking these investments and how can investment promotion by policy makers target "green" investment, including FDI?
- How can developing countries, in the absence of binding targets, show their policy commitment to global greenhouse gas reductions? And how can nationally appropriate mitigation actions (NAMAs) play a role in this?
- And finally, how can public finance mechanisms encourage foreign and domestic investment in low carbon production, and address constraints for private action on climate change mitigation?

Determinants	Policies
<ul style="list-style-type: none"> <li>• Market</li> <li>• Technological capabilities               <ul style="list-style-type: none"> <li>– Capital/finance</li> <li>– Legal framework (IP protection)</li> </ul> </li> <li>• Infrastructure</li> <li>• Natural resources (e.g. solar)</li> <li>• Policy incentives</li> <li>• Sector specific: liberalization (e.g. power generation)</li> <li>• Investment facilitation</li> <li>• CDM: institutional capabilities</li> </ul>	<ul style="list-style-type: none"> <li>• Regulatory regimes (national)</li> <li>• Subsidies</li> <li>• Cap and trade</li> <li>• Emission costs/tax</li> <li>• Quota renewable energy</li> <li>• Sectoral agreements</li> <li>• Trade: border adjustment measures</li> <li>• PPPs: competitive risk/return</li> <li>• "Green production zones"</li> </ul>

[Show Slide 20] Thank you very much.