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Regional integration and foreign direct investment in developing and transition economies

Note prepared by the UNCTAD secretariat

Executive summary

Regional and interregional economic integration efforts are an important feature of today's economic landscape that also impacts on flows of foreign direct investment (FDI). This note examines patterns of FDI in light of selected regional and interregional integration efforts involving various developing regions and transition economies. It suggests a conceptual framework for further analytical work in this area, and poses a number of questions for expert consideration regarding the policy recommendations that could further intensify the mutual relationship between regional integration and FDI for sustainable development.

The note represents research work in progress, and will be updated, including through the first session of the present multi-year expert meeting. Given the constraints on research and the length of documents, this note does not deal with issues related to the development impact of FDI driven by regional integration.

The sections on East and South-East Asia and South Asia benefited from inputs from the Economic and Social Commission for Asia and the Pacific.

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Introduction

1. Significant efforts towards regional economic integration are under way in all regions of the world, involving developing and developed countries alike. These efforts could lead on the whole to increased FDI by opening up sectors for investment and aligning policies for the treatment of foreign investors, through the direct and indirect effects of trade and investment liberalization and market integration, through the harmonization of general policy frameworks, including those for investment, in participating countries, and through direct cooperation on investment projects at the regional level.

2. Lack of progress in multilateral collaboration in trade and investment puts renewed emphasis on regional economic integration efforts in many regions. Key mechanisms for such integration are regional trade agreements (RTAs) and regional economic integration organizations (REIOs). As of the end of 2011, the World Trade Organization had been notified of 221 RTAs in force. Regional investment agreements, such as the Association of Southeast Asian Nations (ASEAN) Investment Agreement, and investment provisions in free trade agreements and other treaties are also emerging. These agreements aim to encourage FDI flows from outside and inside a region by providing a common FDI policy regime or a single integrated market for trade and investment.

3. The experience of long-established and successful regional groups such as the European Union (EU) and the North-American Free Trade Agreement suggests that regional economic integration provides a strong boost to intraregional cross-border investment linkages. The gradual expansion of the EU has also demonstrated that it supports industrial growth, through the relocation of production to lower-cost countries and the regional specialization of production. However, such patterns have so far proved largely elusive to regional groups of developing countries.

4. This note first proposes an analytical framework to examine the relationship between regional integration and FDI. Observing the difficulties in establishing causality and the problems with data availability, the note looks at what occurred to the main regional integration initiatives in terms of FDI. It also covers a few cases of interregional integration encompassing two or more continents. The note concludes with some questions for discussion by experts, including as concerns the applicability and validity of the conceptual framework for future research in this area.

I. A conceptual framework

5. Regional cooperation leads to the creation and, at times, diversion of investment through restructuring within integrated groups. Regional integration efforts generally lead to increased FDI by opening sectors to investment and aligning policies for the treatment of investors. This is prompted by the indirect effect of trade liberalization and market integration, efforts to harmonize general policy frameworks in participating countries, including for investment (protection and liberalization), and direct cooperation on investment projects at the regional level (table 1).

Table 1
Mechanisms of the impacts of regional economic integration on FDI

<i>Mechanisms</i>	<i>Effects on intraregional FDI flows</i>	<i>Effects on FDI inflows from outside the region</i>
Investment liberalization and/or protection provisions in regional agreements	Enables/encourages increased flows from regional investors per se, including existing third-country investors from outside the region	Enables/encourages increased flows from third-country investors not currently established inside the region
Trade and market integration provisions in regional agreements	Enables the reorganization of production at the regional level, including investments and divestments	Attracts new third-country investment through enlarged markets, including within global value chains
Policy harmonization implicit in the implementation of regional agreements	Encourages investment through reductions in transaction costs and perceived risk	Enables/encourages increased inflows if harmonization encompasses investment regulations applicable to third-country investors
Broader pan-regional investment projects (e.g. infrastructure or research and development) made possible by, or integral to, regional agreements	Provides increased investment opportunities	Provides increased investment opportunities

Source: UNCTAD.

Note: The mechanisms and effects are not mutually exclusive.

6. Intraregional FDI may increase as a result of the lifting of investment restrictions (e.g. the liberalization of investment in particular industries) or reducing transaction costs (e.g. due to the elimination of trade barriers among member States or converging policy regimes). Extraregional FDI may increase as a result of an enlarged market size, which is especially important for regional groups of smaller economies, or because of import-substitution effects where regional economic integration implies external barriers to trade (i.e. tariff-jumping FDI). Investment from outside the region may also increase as a result of coordinated efforts to promote investment at the regional level.

7. Regional integration also affects FDI flows as a result of the rationalization of production facilities by transnational corporations (TNCs) within the region, which benefit from the lower costs of intraregional trade. That process can lead to increased FDI flows or to investment diversion when, for instance, reduced trade barriers allow some firms to take advantage of economies of scale by concentrating their activities nationally while serving broader regional markets.

8. Factors that influence the direction and degree of these effects include the form and strength of market integration, the national and regional industrial contexts, and the characteristics of the firms involved. The impact also depends on how institutional arrangements affect firms' decisions on international investment and operations. The final impact is also conditional on the time frame of the analysis. For example, in 2008, a survey

of Japanese TNCs by the Ministry of Trade and Economy suggested that fewer than 10 per cent of firms expected regional integration schemes to significantly affect their international division of labour or production, while double that share expected to benefit from expanded export markets. Yet as of mid-2012, Japan had concluded 13 free trade agreements (FTAs).

9. Empirically, the impact of regional integration on intraregional and extraregional FDI seems to vary considerably by region. The share of intraregional FDI among developing regional groups in total inward FDI is much lower than that for developed regional groups (i.e. EU) (table 2).

Table 2
Intraregional and extraregional FDI projects in selected regional groups
(Billions of dollars and percentage)

Region	Period	(Billions of dollars)			(% share in total)	
		Total ^a	Intra-regional	Extra-regional	Intra-regional	Extra-regional
COMESA	2003–2005	17.9	0.2	17.7	1	99
	2009–2011	34.0	2.6	31.4	8	92
EAC	2003–2005	2.3	0.0	2.3	2	98
	2009–2011	9.9	1.4	8.5	14	86
SADC	2003–2005	23.3	1.0	22.3	4	96
	2009–2011	32.0	3.2	28.8	10	90
ASEAN	2003–2005	58.2	6.3	52.0	11	89
	2009–2011	117.4	14.4	103.0	12	88
SAARC	2003–2005	39.7	0.8	38.9	2	98
	2009–2011	71.6	2.0	69.6	3	97
GCC	2003–2005	43.0	7.0	36.0	16	84
	2009–2011	47.9	11.2	36.7	23	77
MERCOSUR	2003–2005	42.1	1.6	40.5	4	96
	2009–2011	71.3	1.5	69.8	2	98
CEFTA	2003–2005	4.1	0.0	4.1	1	99
	2009–2011	4.4	0.1	4.3	2	98
APEC	2003–2005	425.8	258.7	167.1	61	39
	2009–2011	596.4	344.2	252.2	58	42
EU	2003–2005	325.7	161.2	164.5	50	50
	2009–2011	310.5	129.2	181.3	42	58

Source: UNCTAD cross-border mergers and acquisitions database for mergers and acquisitions, and information from the Financial Times Ltd, FDI Markets (www.fdimarkets.com) for greenfield FDI projects.

Note: Data refer to the sum of the value of cross-border mergers and acquisitions and greenfield FDI projects. Data for the value of greenfield FDI projects refer to estimated amounts of capital investment.

Abbreviations: COMESA, Common Market for Eastern and Southern Africa; EAC, East African Community; SADC, Southern African Development Community; SAARC, South Asian Association for Regional Cooperation; GCC, Gulf Cooperation Council; MERCOSUR, Southern Common Market; CEFTA, Central European Free Trade Agreement; APEC, Asia-Pacific Economic Cooperation.

^a Three-year annual average.

10. Although to some degree it is possible to examine patterns of FDI in light of regional integration efforts, it is extremely difficult to establish causality. It is evident that a range of factors beyond the formation of regional blocs affect FDI. Increased intraregional FDI inflows themselves also contribute to regional integration. In addition, conclusive analysis of the impact of regional integration on FDI would require data on bilateral FDI flows and detailed sectoral data. Such data are not available for most developing regions. The analysis in this note therefore relies on aggregate FDI data or selected data only.

II. Major findings by region

1. Africa

11. The adoption of the Lagos Plan of Action in 1980 marked the beginning of the renewed push towards enhancing cooperation across the continent. The Plan promoted a regional approach to furthering economic development, and as a consequence, the 1980s and 1990s saw a proliferation of REIOs on the continent. Most of the 17 REIOs in force today were formed during these two decades (figure 1). As a consequence of the number of REIOs, several African countries have become members of more than one group. In fact, only three countries (Algeria, Cape Verde and Mozambique) are members of just one REIO, with the remaining breakdown as follows: 14 countries are members of two groups, 19 are members of three, 16 are members of four and one (Côte d'Ivoire) is a member of five. In addition, African countries have concluded 19 RTAs with economies outside the continent.

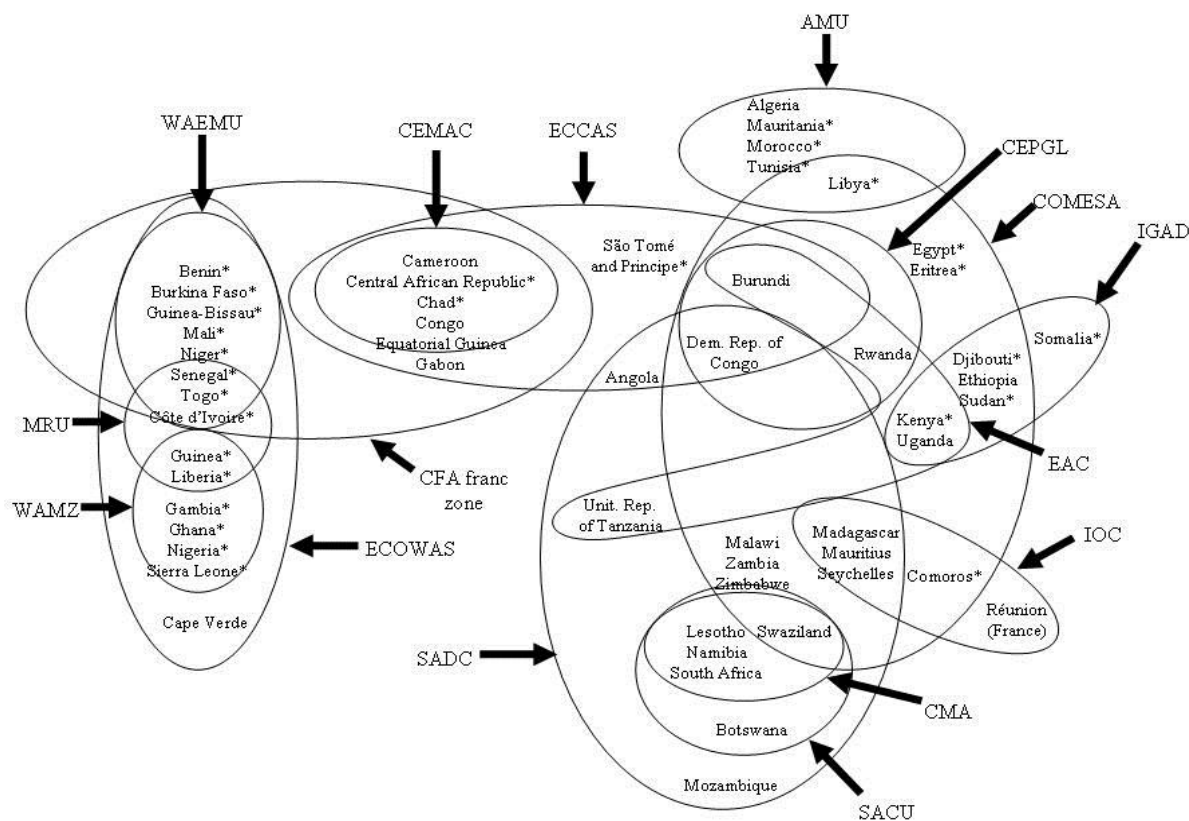
12. Despite the large number of regional integration initiatives, their impact on generating or attracting more FDI has been, by and large, limited. Focusing on the milestones in five of the main REIOs (COMESA, EAC, Economic Community of Central African States (ECCAS), Economic Community of West African States (ECOWAS) and SADC), using the crude method of comparing the average percentage of FDI relative to gross domestic product (GDP) reveals that in most cases FDI fluctuated and in certain cases – such as the introduction of the COMESA Common Investment Area – even declined (figure 2). Intraregional FDI also remained at low levels, though its share in total FDI inflows rose over the past decade (table 2).

13. Studies on African REIOs have generally identified three issues that contribute to their relative ineffectiveness on FDI:

(a) The proliferation of REIOs has itself resulted in the inadequate payment of member contributions, low implementation of programmes, duplication or implementation of conflicting programmes and low attendance at meetings. Furthermore, overlapping memberships have hindered the harmonization of policy and institutional frameworks and thus efforts towards deeper integration.

(b) There is limited coverage of investment issues. Even in REIOs that have relatively extensive coverage of investment-related issues, the provisions are often fairly general in formulation and application. A survey of the REIOs revealed that investment issues had lower priority than peace and security; free movement of persons, goods, capital and services; agriculture; and infrastructure and energy.

Figure 1
The networks of intraregional agreements



Source: Figure updated from UNCTAD (2009), *Economic Development in Africa 2009: Strengthening Regional Economic Integration for Development*. United Nations publication. Sales No. E.09.II.D.7. New York and Geneva.

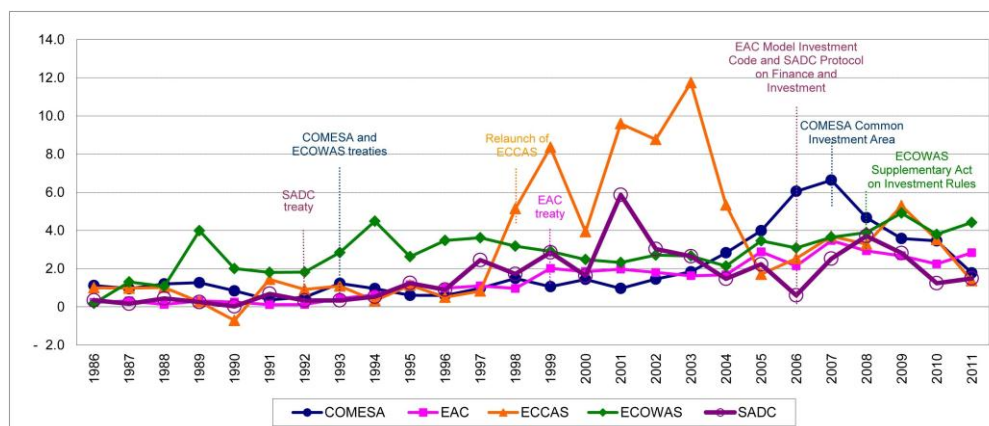
Abbreviations: AMU, Arab Maghreb Union; CEMAC, Central African Economic and Monetary Community; CMA, Common Monetary Area; CEN-SAD, Community of Sahelo-Saharan States; CEPGL, Economic Community of the Great Lakes Countries; IOC, Indian Ocean Commission; IGAD = Intergovernmental Authority on Development; MRU, Mano River Union; SACU, Southern African Customs Union; WAEMU, West African Economic and Monetary Union; WAMZ, West African Monetary Zone.

* Members of CEN-SAD.

(c) There is a general lack of progress in practical implementation. African REIOs have had a tendency to strive for far-reaching integration within overly ambitious time frames. As a consequence, the formation of free trade areas and customs unions has not always been fully implemented and deadlines have often been missed.

14. In order to address these weaknesses in past integration efforts, the creation of a pan-African REIO has long been on the agenda for African policymakers. The most significant step in this regard was the adoption of the Treaty Establishing the African Economic Community in 1991 (also known as the Abuja Treaty). The provisions of this treaty ensure the free movement of capital within the community through the elimination of restrictions on capital transfers.

Figure 2
Evolution of FDI inflows to five REIOs as a percentage of GDP, 1986–2011
 (Percentage)



Source: UNCTAD, FDI/TNC database.

15. Notwithstanding the limited impact of regional integration on FDI inflows to the continent thus far, there are reasons to be cautiously optimistic about future prospects. For instance, REIOs have made investment issues more prominent in their policies and pushed for greater harmonization of investment policies in recent years. The greater scale and scope of investment provisions in COMESA, ECOWAS and SADC is one manifestation of this trend.

16. There is also recognition that the multiple and overlapping memberships in regional blocs can hamper the potential gains from regional integration. Following on the aspiration expressed in the Abuja Treaty to create a pan-African bloc, the African Union decided in 2006 to suspend, until further notice, the recognition of new REIOs with the exception of eight (AMU, CEN-SAD, COMESA, EAC, ECCAS, ECOWAS, IGAD and SADC).

17. An interesting initiative in this context is the COMESA-EAC-SADC Tripartite which seeks to enhance cooperation and harmonization among the three REIOs. This will include the formation of a free trade area among the triumvirate, negotiations for which got under way in mid-2011. The “Draft Agreement Establishing the COMESA, EAC and SADC Tripartite Free Trade Area” currently under negotiation stipulates that members undertake to create a single investment area, develop policies and strategies which promote cross-border investment, reduce the cost of doing business in the region, and create a conducive environment for private sector development. Since the Tripartite seeks coherence among three of the main REIOs, it is likely that it will contribute to progress towards an African Economic Community.

18. Another cross-regional initiative is the Minimum Integration Programme, which is a mechanism for convergence between REIOs and focuses on a few priority areas including investment. The objective of the first phase is to establish a regional and continental platform to promote investment. Doing so will entail establishing regional investment protocols, harmonizing them, formulating a continental investment code and accelerating the establishment of the African Investment Bank.

19. Making the coverage of investment provisions extensive and comprehensive and fully implementing these provisions are paramount preconditions for increasing the impact of regional integration on FDI flows to the countries concerned. A lack of coordination and consistency remain general problems in regional integration in Africa and particularly so for investment.

2. East and South-East Asia

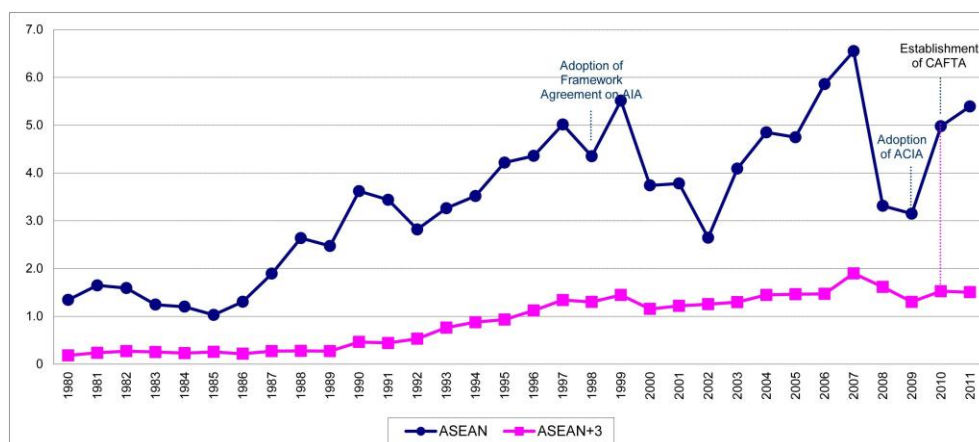
20. Regional economic integration in developing East and South-East Asia has accelerated since the Asian financial crisis in 1998. ASEAN has been at the centre of the process, alongside major regional economies, including China, Japan and the Republic of Korea. Collectively, ASEAN and these three economies are known as ASEAN+3, though each of the three economies has a separate economic arrangement and relationship with ASEAN. Economic integration has evolved beyond the geographical scope of East and South-East Asia and affected the broader regional integration process through various mechanisms, such as the Asia-Pacific Trade Agreement (APTA), the East Asia Summit, the Asia-Pacific Economic Cooperation and, more recently, the Trans-Pacific Partnership.

21. Since its establishment in 1967, ASEAN has made great efforts to improve regional connectivity (i.e. trade, investment, transport, trade facilitation, information and communications technology, energy, human movement and financial cooperation) and integration. In 2003, the decision to create an ASEAN Economic Community by 2020 represented an important milestone in regional economic cooperation. In 2007, ASEAN decided to accelerate the deadline to 2015. ASEAN's economic links with the rest of the world have not weakened as intraregional linkages have been strengthened. Fast-growing developing countries within developing Asia (China, India and the Republic of Korea) and developed countries in Asia and the Pacific (Australia, Japan and New Zealand) now belong to a group of dialogue partners with which ASEAN meets regularly to discuss broad regional and global interests. Together they work towards forming an East Asian community.

22. With regard to regional investment cooperation, ASEAN has made significant progress. In 1998, ASEAN members signed the Framework Agreement on the ASEAN Investment Area (AIA), which aimed to make ASEAN a competitive, conducive and liberal area for investment by undertaking various concerted measures. In 2009, the ASEAN Comprehensive Investment Agreement (ACIA) consolidated the 1998 Framework Agreement on AIA and the 1987 Agreement for the Promotion and Protection of Investments (also known as the ASEAN Investment Guarantee Agreement). At the ASEAN Economic Ministers Meeting in August 2011, ministers agreed to further propel implementation of the organization's programmes towards 2015, focusing on initiatives to enhance the promotion and facilitation of investment.

23. The Framework Agreement on AIA and its implementation have improved the investment environment in ASEAN, which has translated into enhanced competitiveness of the regional group in attracting FDI and increased FDI inflows. The AIA was established in part to address the negative effects of the Asian financial crisis, and it seems to have achieved its objective of restoring investors' confidence in ASEAN. In 2000, two years after the signing of the Framework Agreement on AIA, ASEAN's share in global FDI inflows dropped to less than 2 per cent, but it rose to nearly 5 per cent in the mid-2000s. It is still too early to assess the effect of ACIA on FDI inflows, but ASEAN's share in global FDI reached more than 6 per cent in 2011. In addition, in terms of FDI as a percentage of GDP, the trend in FDI flows supports a positive evaluation of the effectiveness of the AIA, except during the Asian financial crisis and the recent global crisis (figure 3).

Figure 3
Evolution of FDI inflows to ASEAN as a percentage of GDP, 1980–2011
 (Percentage)



Source: UNCTAD, FDI/TNC database.

Abbreviation: CAFTA, China-ASEAN Free Trade Area.

24. There is some evidence that investment-specific efforts in the regional integration process have encouraged intra-ASEAN FDI, for example, by granting ASEAN investors national treatment and greater access to industries. In addition, trade liberalization has expanded the regional market and enhanced both awareness of and the attractiveness of the ASEAN subregion as a location for international investment. These efforts have promoted the ASEAN subregion as a single investment destination, making investors from countries outside the regional grouping adopt a regional investment strategy and establish regional networks of operations. As a result, the share of intra-ASEAN FDI in total FDI to ASEAN countries has increased over the past years.

25. Project-level data demonstrate that increasing greenfield FDI investment has been recorded in manufacturing since the adoption of the AIA, particularly in recent years. Low-income countries in ASEAN, including Cambodia, Laos People's Democratic Republic, Myanmar and Viet Nam, have benefited from growing investment from member States that are economically more advanced, such as Malaysia, Singapore and Thailand, as well as from East Asian economies, such as China and the Republic of Korea. This indicates a flying geese pattern of regional industrial upgrading – the process of making headway in industrialization by less advanced economies. Increased intraregional FDI has accelerated the development of international production networks within ASEAN, and the experience of a number of low-income countries in industries such as textile and garment has highlighted the associated benefits. This trend has been enhanced by the Initiative for ASEAN Integration, which was launched by ASEAN member States in 2000 to narrow the development divide between ASEAN and Cambodia, Laos People's Democratic Republic, Myanmar and Viet Nam and enhance the competitiveness of ASEAN as a whole.

3. South Asia

26. In South Asia, progress in regional economic integration has been weak and slow, and investment issues have not yet been included in the process. As a result, the region has not realized its potential to attract FDI inflows associated with regional integration, especially intraregional ones. Since the mid-2000s, strong economic growth in major economies in the subregion has created momentum for regional integration, and South

Asian countries have increasingly realized that regional integration can help them improve the climate for investment and business. The inclusion of an investment agenda in the regional integration process and in particular the creation of a regional investment area can play an important role in this improvement.

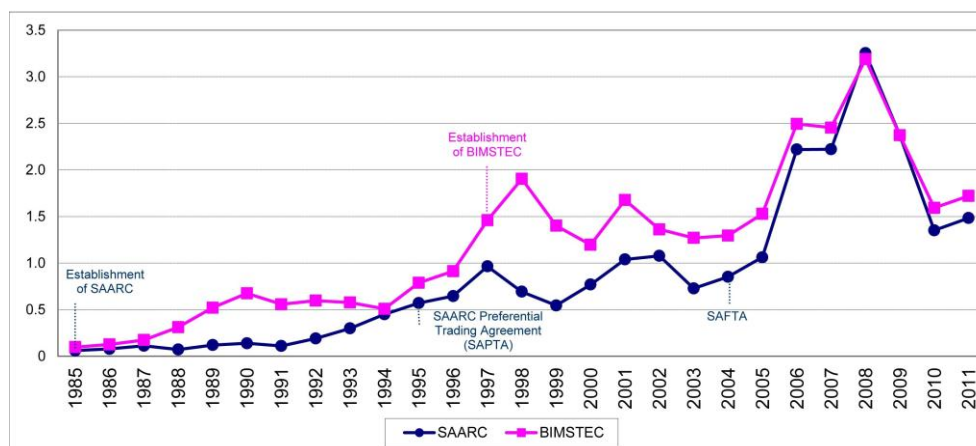
27. SAARC, formed in 1985 by Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, has been the key architect of regional integration; Afghanistan joined in 2007. SAARC initiated trade integration in 1995 when the SAARC Preferential Trading Agreement took force, which was replaced in January 2004 by the South Asian Free Trade Area (SAFTA) that commenced trade liberalization in July 2006. In terms of investment, SAARC member States agreed to consider the adoption of measures to remove barriers to intra-SAARC investments already under the SAFTA Agreement. This was reinforced by the SAARC Agreement on Trade in Services in 2010 which extended the SAFTA agreement to services.

28. In 1997, with technical support from the Economic and Social Commission for Asia and the Pacific, a new subregional group was formed. The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) was formed to enhance economic and social development among member nations, promote cooperation and provide assistance in training and research as well as in other areas of common interest. Its creation could be seen as forming a link between ASEAN and SAARC. BIMSTEC, initially focused on sectoral cooperation, formed a free trade area in 2004. In 2011, a permanent secretariat was established in Dhaka as a channel for member countries to voice concerns and monitor activities.

29. Because of the slow progress of the SAFTA process, SAARC members have put emphasis on forging bilateral ties. Among these, the India–Sri Lanka FTA has been successful in boosting FDI flows. After it came into force in 2001, FDI inflows from India to Sri Lanka surged, as India jumped from one of the top 10 providers of FDI in Sri Lanka in 2000 to the fourth largest in 2005. FDI flows from Sri Lanka to India also increased. A main reason the FTA has boosted FDI is that low tariffs allow Indian investors to send raw materials to Sri Lanka and then re-export products back to India. In the first half of 2011, India remained the third largest contributor of FDI to Sri Lanka (\$47 million). Overall, however, intra-SAARC FDI accounted for only 3 per cent of total FDI inflows (table 2). Other FTAs (e.g. the Pakistan-Sri Lanka FTA) have not been successful in boosting FDI.

30. South Asia is perhaps one of the least integrated developing regions in the world. Progress in regional economic integration has been far short of the potential, and the barriers to trade and investment between neighbouring countries are among the highest in the world, despite efforts to liberalize trade. As a percentage of GDP, FDI flows to this group have not only been smaller (figure 4) but also have increased less than those to other regions such as ASEAN (figure 3).

Figure 4
Evolution of FDI flows to SAARC and BIMSTEC as a percentage of GDP, 1985–2011
 (Percentage)



Source: UNCTAD, FDI/TNC database.

31. To boost investment flows to and within South Asia, countries in the region could consider accelerating their regional integration efforts, with special emphasis on regional investment integration.

4. West Asia

32. Economic diversification is a shared objective among the six Arab Gulf countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – that founded GCC in 1981. Its importance was emphasized in the economic agreement among GCC countries signed in 2001, which provided for further economic integration among member States. It has recently taken high political priority, as the lack of job prospects for a rapidly growing, educated and young population was a key trigger of political unrest in the Arab countries.

33. The surge of oil prices since the late 1990s has given GCC countries a new opportunity to achieve changes in their economic structures by utilizing their accumulated oil revenues. In contrast with previous years, the private sector was encouraged to participate more actively in this new phase of economic diversification efforts. This is reflected in the 2001 economic agreement between GCC countries that highlighted the need for “enhancing local, external, and intra-GCC investment levels, and provide an investment climate characterized by transparency and stability” (Economic Agreement Between the GCC States, Article 5, 31 December 2001).

34. Concrete policy measures have been taken at national and group levels to ensure greater economic liberalization. At the GCC level, countries agreed to foster economic integration by significantly reducing barriers to free movement of goods, services, labour and capital between member States, and by allowing nationals of GCC member States to acquire real estate and invest in the stock markets of all member States. At the national level, all the countries have undertaken privatization programmes and have adopted new FDI policies involving more liberal entry, fewer performance requirements, more incentives, more guarantees and protection, and the removal of regulatory and administrative barriers, although actual implementation differs by country and from one area of economic activity to another.

35. This policy shift has resulted in a strong increase in FDI flows to and from GCC countries since 2003. The new policy framework, together with the new business opportunities offered by the surge of oil revenues, has increased inflows to the group as a whole from a relatively modest \$1 billion a year on average between 1990 and 2000, to \$28 billion in 2001–2011, reaching a record of \$60 billion in 2006. FDI stock in the GCC countries increased tenfold in a decade, directed mostly to Saudi Arabia, followed by the United Arab Emirates, the two biggest economies.

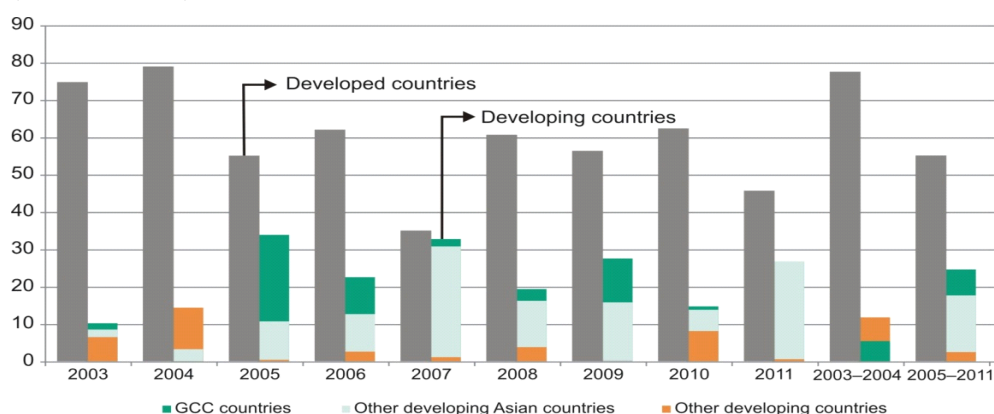
36. During the 2000s, in contrast with the pattern in previous years, the services sector became the main destination of FDI inflows to GCC countries. Available stock data from three GCC countries show that in 2010, this sector accounted for 42 per cent of inward FDI stock, the manufacturing sector for 35 per cent and the upstream oil and gas industry for 16 per cent. The services sector was also predominant in greenfield FDI projects, attracting 55 per cent of their total estimated amount in 2003–2011, while 40 per cent targeted the manufacturing sector and 5 per cent went to the extractive industry.

37. The geographical origin of FDI inflows during the 2000s has also become more diversified. In Saudi Arabia, for example, between 2000 and 2010 FDI stock from developed countries increased almost seven-fold, while the share in total FDI stock of those countries declined from 80 to 56 per cent. This shift was caused by the surge of FDI from developing Asian countries, whose share jumped from 18 to 39 per cent. In particular, the GCC countries increased the amount of their FDI stock in Saudi Arabia twentyfold, which increased their share from 10 to 22 per cent. Data on greenfield FDI projects confirm the increasing importance of developing Asian countries as sources of FDI in the GCC countries, as well as the particular surge of intra-GCC FDI (figure 5).

Figure 5

Greenfield FDI projects in GCC countries by geographical origin, 2003–2011, and 2003–2004 and 2005–2011 averages

(Share of the total)



Source: UNCTAD, based on Financial Times Ltd, FDI Markets (www.fdimarkets.com).

38. The attractiveness of GCC countries to FDI was bolstered by strong oil revenues which boosted economic growth and domestic demand. It also stemmed from the openness of a wider range of activities to FDI, and from the governments' active industrial policy, which used oil revenues to establish projects and encourage foreign investors to participate for example, in petrochemicals and petroleum refining, and the building of economic zones and new cities. Remaining restrictions on private participation in upstream hydrocarbon activities considerably limited investment in the non-primary activities.

39. The soaring oil prices and increasing refining margins in the 2000s encouraged Gulf countries to establish refinery/petrochemical complexes to produce products with higher

value added. They also opened the door wider to international oil companies, as providers of technologies and market experience. Several projects have been built or are under way through joint ventures or non-equity agreements with foreign TNCs. Several are hosted in Saudi Arabia, such as Petro Rabigh (with Sumitomo Chemical (Japan)), Al Jubail (with Total (France)), Fujian (with ExxonMobil (United States of America) and Sinopec (China)). Similar projects also took place in Oman, Qatar and the United Arab Emirates.

40. GCC countries clearly experienced higher growth in their non-oil sectors during the 2000s, and the shift in their FDI policy in the early 2000s allowed foreign direct investors to participate in this process. Progress in the equal treatment of GCC-country citizens in freedom of movement, work, residence, engaging in economic activities, capital movement and real estate ownership has spurred intra-GCC FDI, which has helped develop services activities. A step forward in the GCC integration scheme might be to link and coordinate progressively the various national diversification efforts and advance towards designing an integrated regional diversification strategy in order to avoid the excessive duplication of production facilities and reduce the risk of oversupply.

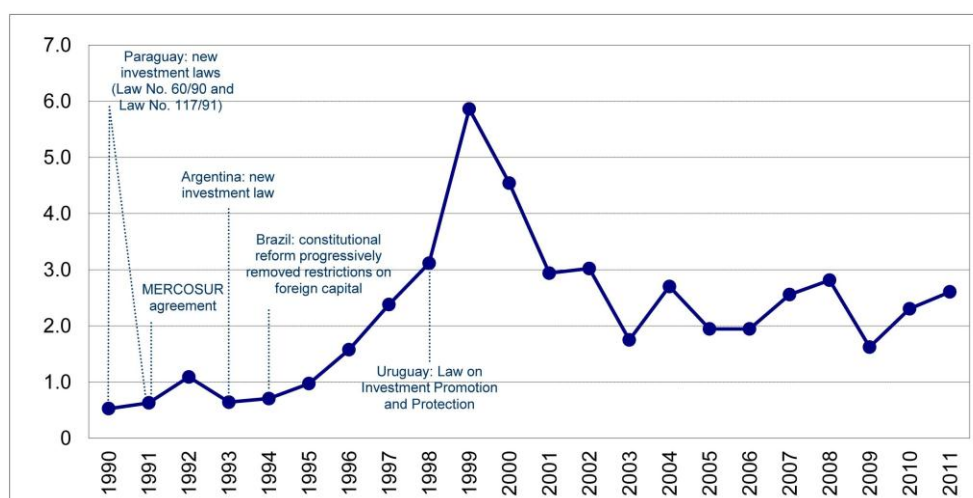
5. Latin America and the Caribbean

41. MERCOSUR is the most ambitious economic integration project in the region. Argentina, Brazil, Paraguay and Uruguay were the founding members. In 2008, Venezuela, Chile and Bolivia became associate members. Peru, Ecuador and Colombia have expressed their willingness to join the group, and Mexico has shown a growing interest. Venezuela became a full member in July 2012.

42. Initiated by the Treaty of Asunción in 1991, MERCOSUR aimed at creating a free trade area, then a customs union with the adoption of a common external tariff, and finally a common market. At the national level and during the 1990s, all MERCOSUR countries implemented economic reforms with varied scope and intensity, leaving behind the import-substitution industrialization model. The new policy orientation, intended to allow markets to direct resource allocation rather than governments, included a shift in FDI policies involving more liberal entry, incentives, more guarantees and protection, equal treatment, and the removal of regulatory and administrative barriers. In particular, vast privatization programmes were implemented in Argentina and Brazil covering a wide spectrum of activities, including public services and hydrocarbons. In 1994, MERCOSUR's members signed agreements for common provisions promoting and protecting FDI (the Buenos Aires Protocol and the Colonia Protocol). However, these agreements are still not ratified by any of the member States.

43. FDI to MERCOSUR countries increased strongly during the 1990s, especially between 1995 and 1999, then registered a strong decline in 2000 (figure 6), before resuming robust growth in 2003. It is difficult to disentangle the role of the MERCOSUR agreement in FDI growth from the other changes that took place throughout these years. The opening up of a wide range of activities previously closed to FDI, massive privatizations and a more favourable macroeconomic climate accompanied the FDI boom of the 1990s. The economic recession between 1998 and 2002 preceded the decline in FDI in 2000–2003. The new wave of FDI flows since 2004 went along with the continued increases in commodity prices which inaugurated a new phase of economic growth and development opportunities in MERCOSUR countries, which are all important exporters of commodities. While intra-MERCOSUR investments have been limited (table 2), the MERCOSUR agreement has contributed to FDI growth with variance by sector.

Figure 6
Evolution of FDI flows to MERCOSUR as a percentage of GDP, 1990–2011
 (Percentage)



Source: UNCTAD, FDI/TNC database.

44. After a period of open regionalism and liberalizing reforms, a shift in MERCOSUR's integration model has occurred since the early 2000s. The two main MERCOSUR economies (Argentina and Brazil) entered a new phase marked by the re-evaluation of the role of the State in the economy and the rehabilitation of the concept of industrial policy, which is slowly returning after practical exclusion from the market-led economic model of the 1980s and 1990s. Argentina in 2001 and Brazil in 2003 began announcing plans to promote specific sectors and activities. A defining element in the change that has taken place in MERCOSUR is the importance given to strategic State action in defence of national development interests.

45. More recently, the global economic crisis accelerated this shift towards industrial policy. Argentina and Brazil implemented policies to support industries not only by fostering investment, innovation and foreign trade, but also by protecting the domestic market and local manufacturing – already weakened by the appreciation of local currencies – from the flood of cheap manufacturing goods seeking to counter weak demand in the United States and Europe. Both countries want their local industries to capitalize on their domestic consumption boom and aim to establish a home-grown high-technology industry that will help them to diversify their economy and move up the value chain.

46. At the national level, these measures include higher tariff barriers, more stringent criteria for licences and increased preference margins for domestic production in public procurement. At the MERCOSUR level, members agreed in December 2011 to impose a 35 per cent tariff, the maximum allowed under World Trade Organization rules, on 100 additional goods, subject to MERCOSUR's common tariff on imports from outside the bloc. The new tariffs will be imposed until December 2014. Capital goods, textiles and chemical imports are the targets.

47. These policy changes may induce barrier-hopping FDI in MERCOSUR countries. Indeed, they seem to have had an impact on the strategy of TNCs. In Brazil, TNC automobile manufacturers announced a flurry of investments in the automotive sector at the end of 2011. In addition, after being granted tax incentives, Foxconn plans to build five additional factories in Brazil. In Argentina, in the context of a boom in agriculture exports and the domestic automobile market (with growth at about 30 per cent per year), the

Government began negotiating in 2011 with automobile manufacturers and agriculture-machinery producers to source and produce locally. In the same year, a number of TNCs announced new investments in the country.

48. MERCOSUR appears to be shifting towards a new model of development and regional integration in which individual governments have active policies and strategies for promoting industrialization and competitiveness, and broader development goals. These mostly centre on the national levels. However, there is also scope for the coordination of respective national policies with a view to reinforcing regional economic links and promoting productive complementarities between countries as a means to increase competitiveness and intensify trade relations.

6. Transition economies

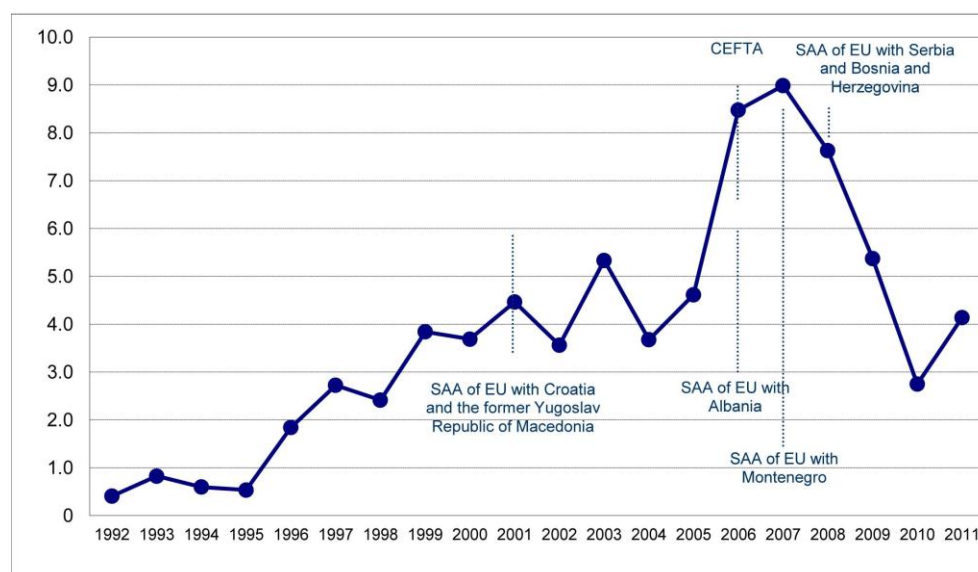
49. Over the past two decades, transition economies have carried out massive reforms aiming to establish an open market economy. They have undergone three main stages: (a) stabilization and structural adjustment programmes; (b) reform of the legal and regulatory framework; and (c) industrial competitiveness and regional cooperation policies to reap economies of scale in production and to increase firm-level capability building. Liberalization of investment started later than liberalization of trade and other international transactions, typically in the mid- or late-1990s. National liberalization took place simultaneously with exogenous liberalization, namely, the acceptance of investment liberalization commitments in preferential regional integration arrangements and multilateral obligations. In regional arrangements, the need for rules on investment liberalization was prompted by the obsolescence of old regional agreements; the new agreements had to be adjusted to the needs of market-based investment flows.

50. South-East European countries are following a two-pronged strategy: First, they have been upgrading their institutions and investment policies to bring them in line with EU standards. Investment policy is one of the most advanced dimensions of policy reform in South-East Europe. All countries have created a liberal regime to attract FDI, providing equal treatment of foreign and domestic investors (national treatment), guarantees against expropriation and the free transfer of funds.

51. Second, South-East European countries have joined regional agreements such as CEFTA, which opened to most of these countries in 2006 (with the exception of Croatia, which had joined in 2003). This agreement, which contains an important investment chapter, represents a significant accomplishment along the path to EU accession and an important stepping stone to sustainable long-term growth. Indeed, South-East European countries and the EU both consider CEFTA an important mechanism of preparation for prospective EU membership. EU-supported regional integration has proved to be a particularly efficient instrument for advancing policy reform in all areas, including investment through, for example, the Stabilization and Association Agreement (SAA).

52. In the 1990s, a series of security shocks created a region that was averting investments rather than attracting them. Following the stagnation of FDI as a share of GDP in 2002–2005, FDI flows increased steeply until the global financial crisis hit the main investing countries in 2007 (figure 7).

Figure 7
Evolution of FDI inflows to CEFTA member countries as a percentage of GDP, 1992–2011
 (Percentage)



Source: UNCTAD, FDI/TNC database.

53. Within the region, the removal of internal trade barriers reduced horizontal (market-seeking) FDI by weakening the incentive of CEFTA-based companies to use FDI as a tariff-jumping device. By contrast, vertical FDI within the region may be stimulated by the removal of internal trade barriers, especially when member countries are at different stages of economic development. While the share of intra-CEFTA inflows in total investment projects remained low at 2 per cent (table 2), intra-CEFTA outflows accounted for a considerable share – almost two thirds for greenfield FDI investments in 2008.

54. The Commonwealth of Independent States countries signed a large number of regional agreements with each other to resuscitate former linkages after the collapse of the Soviet Union. The EuroAsian Economic Community is one of the most notable ones. In 2008, an agreement on encouragement and mutual protection on investments within the member States was signed, with provisions that the parties should create favourable conditions for their implementation, allow such investments in accordance with their laws, and guarantee and protect investments from each other's economies. The cooperation among EuroAsian Economic Community countries in transportation and energy would foster intraregional FDI through the participation of these countries in common hydroelectric energy projects in Central Asia.

55. Empirical evidence suggests that membership in REIOs such as CEFTA contributes to larger FDI inflows, but only in conjunction with other factors such as overall reforms in the investment regime and macroeconomic stability.

7. Interregional groups

(a) Asia-Pacific Economic Cooperation

56. Among interregional groups, the Asia-Pacific Economic Cooperation (APEC) is perhaps exceptional in successfully attracting and facilitating FDI. Driven by common

goals and shared commitment (e.g. Bogor Goals), APEC has emerged as an engine of global economic growth over the last decade and half, outpacing the rest of the world. The 21 APEC member economies, in opening themselves to international trade and investment, increased their share of global output and trade. Indeed, in 2011, these economies accounted for 40 per cent of world population and 56 per cent of world GDP. FDI inflows into APEC economies reached \$778 billion in 2011, accounting for almost half of global FDI flows. Intra-APEC FDI flows and stocks are placed in an important position in its FDI. The share of intra-APEC FDI inflows reached about 40 per cent in 2011.

57. The interaction between unilateral and international liberalization and facilitation is a salient pattern of APEC dynamics, with a different pace of liberalization taking into account differing levels of economic development among APEC economies. It is apparent that considerable progress in the liberalization and facilitation of investment regimes by member economies has been achieved over the past 15 years and has been an important factor for FDI, including intraregional FDI.

58. As experienced by this group, while efforts at the firm level are important to investing between partner countries/regions, the interaction between individual country efforts and regional initiatives is instrumental in promoting FDI. Governments can also help forge investment relationships, including by strengthening relationships between investors and domestic firms. Given the advantages offered by the respective regions, greater investment by firms from partner regions, in the context of increased economic cooperation supported by regional initiatives, can only mutually enhance growth in all regions involved.

(b) Other interregional groups

59. Several other interregional groups encompassing continents and involving developing regions have emerged, but have so far had little effect in attracting interregional FDI. In other words, FDI flows unilaterally from a larger market or a more advanced region to a smaller market or a less advanced region, and at a low level. For example, with the objective of strengthening the EU relationship with the countries in the Mashriq and Maghreb regions, the Euro-Mediterranean Partnership was established in 1995. This partnership today comprises 44 members – 27 EU member States and 16 partner countries. EU FDI flows into these 16 countries have remained relatively small (only 2.5 per cent in 2010), however, and is concentrated in only a few host countries (Croatia, Egypt, Israel, Morocco, Tunisia and Turkey). FDI from these countries into the EU is negligible. While the low level of FDI from the partner countries into the EU does not surprise given the size and development of these individual economies, the low level of EU FDI in these partner countries runs contrary to the investment promotion efforts that could be expected as a result of partnership relations with the EU. This can be attributed to several possible factors, including potentially a lack of regional policies towards FDI at the regional level. Recent political crisis added another element. FDI in the five AMU countries, for instance, represents only 1.7 per cent of GDP in 2011 as compared with 3.0 per cent for all developing countries.

60. With investment flows running from Asia to Africa, major efforts are made at the individual country level, for example, to promote cooperation in China and India. These national efforts to increase FDI flows from Asia to Africa could benefit from active and practical cooperation between institutions in both regions. One example in this regard is the declaration of a New Asian-African Strategic Partnership adopted at the Asian-African Summit in 2005 which emphasizes the need to promote economic cooperation among Asian and African countries, including in the area of investment.

III. Issues for discussion

61. The experiences examined above suggest that a number of key issues require careful consideration to understand the relationship between regional integration and FDI inflows; and what can be done to augment their relationship.

62. The first issue relates to the role of regional integration as a determinant of FDI and the difficulty of establishing causality between the two, in particular as the counter-factual is difficult to ascertain. The scarcity of available data to test causality – and indeed its direction – between the two adds to the difficulties. A second issue concerns the primary importance of economic and policy fundamentals. Although market size is a key determinant, it appears that forming a larger (and potentially more prosperous) economic grouping may not necessarily bring benefits, especially in terms of attracting FDI, if the appropriate economic conditions and an enabling policy framework are not in place.

63. In terms of the economic fundamentals, a major question is to what extent the proactive pursuit of investment liberalization among member States involved in the regional integration process directly increases FDI flows or whether they would increase (indirectly) due to the enlarged market opportunities for TNCs to service (and source within) an entire region as a result of the region's trade integration. As stated in UNCTAD's Investment Policy Framework for Sustainable Development (IPFSD), enhanced trade integration at the regional level is considered a key factor in promoting investment (IPFSD national policy guideline 3.1.1 (Trade policy)).* At the limit, the question could also extend to whether, to what extent and why FDI might have occurred in a region without any regionalization efforts. In addition, it is also appropriate to ask to what extent regional integration efforts could create additional unintended hurdles to FDI (e.g., unnecessary administrative burdens, bureaucratization and over-regulation that regional integration efforts might entail).

64. In terms of the enabling policy framework, a crucial question is whether the regional integration effort is appropriate and viable and, as a corollary, fully encompasses essential investment liberalization and investment policy harmonization for sustainable development. This requires consistency in, and coordination of, investment policies. As already stipulated in IPFSD, coherent policy approaches in a number of areas are essential to ensure that investment contributes to the pursuit of development objectives. Regional integration efforts multiply the challenges in this regard. This is not limited to the fact that domestic investment policies need to be coherent throughout the regional group in question and in line with regional investment and other policy domains, such as trade, competition and the environment. It also relates to the policy dimension of the balance a country wishes to strike between regional policy harmonization and its own right to regulate in the public interest.

65. Another issue concerns whether membership in a REIO positively impacts FDI through a perceived reduction of risks and the signalling effect it could have to potential investors. By joining a larger REIO, a country could reassure investors that its policy reforms are irreversible, thus enhancing confidence among potential investors.

66. In this light, experts may address the following questions:

- Is the conceptual framework proposed in this note sufficient and sound? How can it be applied to real life situations?

* UNCTAD (2012). *World Investment Report 2012: Towards a New Generation of Investment Policies*.

- How can one obtain (better) data to periodically assess and evaluate the impact of regional integration on attracting and benefiting from FDI? How could UNCTAD and other international organizations help in this regard?
 - What ways and means of assessing the impact of regional integration on attracting and benefiting from FDI can be used, and what are their weaknesses and strengths? How can the counterfactual be established?
 - Under what circumstances can regional integration in the area of trade also bring benefits in the area of investment? What are the risks involved? What investment-specific aspects are important to include in regional integration agreements and how can a coherent whole be ensured?
 - Given the increased role of the trade/investment nexus and of global value chains, what are the implications for regional integration? How can regional integration be further strengthened in terms of encouraging regional value chains and cross-border industrial clustering? What are the policy instruments that apply, and their weaknesses and strengths?
 - What aspects need to be borne in mind to ensure that regionalisation and regional value chains support countries participation in global value chains – to the extent desirable – and maximize the attendant development benefits (while minimizing the costs and risks)?
 - How can coherence be ensured in policy at the level of member country trade and investment measures, between the investment chapter (of the REIO) and other international investment agreements, and between investment policies vis-à-vis other policies?
 - How can ensure an appropriate balance be ensured between regional policy coherence and harmonization and a country's right to regulate in the public interest? What institutional mechanisms are needed?
 - What are the do's and don'ts of regional integration in this regard? What lessons can be drawn from existing work, including this note? What aspects require clarification? In this regard, and with regard to the other issues above, what should be the future policy research agenda?
 - What mechanisms at the multilateral level could be established or adapted to facilitate the exchange of experiences and lessons learned among regional groups?
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