World Investment Report 1996

Investment, Trade and International Policy Arrangements

Overview

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Foreign direct investment (FDI) has been growing rapidly in the recent past, faster, indeed, than international trade, which has long been the principal mechanism linking national economies. Moreover, as the global environment is changing and strategies of transnational corporations (TNCs) evolve, new configurations of TNC activities are emerging. This focuses renewed attention on what FDI means for trade, how FDI and trade are interlinked, and whether and how these interlinkages influence the economic growth and welfare of countries, particularly developing countries. These issues are of particular interest in the context of national policies for FDI and trade. But at a time when negotiations and discussions on international arrangements for investment are under way in various forums, they are also of interest at the international level. They are the special topic of this year's *World Investment Report.*

Table 1. FDI inflows and outflows, 1983-1995

(Billions of dollars and percentage)

Year	Developed countries		Developing countries		Central and Eastern Europe		All countries	
	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
Value (*Billions of dollars*)								
1983-1987	58.7	72.6	18.3	4.2	0.02	0.01	77.1	76.8
1988-1992	139.1	193.3	36.8	15.2	1.36	0.04	177.3	208.5
1990	169.8	222.5	33.7	17.8	0.30	0.04	203.8	204.3
1991	114.0	201.9	41.3	8.9	2.45	0.04	157.8	210.8
1992	114.0	181.4	50.4	21.0	3.77	0.10	168.1	203.1
1993	129.3	192.4	73.1	33.0	5.59	0.20	207.9	225.5
1994	132.8	190.9	87.0	38.6	5.89	0.55	225.7	230.0
1995	203.2	270.5	100.2	47.0	12.08	0.30	315.4	317.8
Share in total (*Per cent*)								
1983-1987	76	95	24	5	0.02	0.01	100	100
1988-1992	78	93	21	7	0.77	0.02	100	100
1993	62	85	35	15	2.70	0.09	100	100
1994	59	83	39	17	2.60	0.24	100	100
1995	65	85	32	15	3.80	0.09	100	100
Growth rate (*Per cent*)								
1983-1987	37	35	9	24	-7	68	29	35
1988-1992	-4	3	15	16	298	46	1	4
1993	13	6	45	52	46	99	24	11
1994	3	-1	19	17	7	179	9	2
1995	53	42	15	22	106	-45	40	38

Source: UNCTAD, *World Investment Report 1996*, p. 4.

Global and regional trends

World FDI flows reached a record high in 1995, . . .

Investment inflows in 1995 increased by 40 per cent, to an unprecedented $315 billion. Developed countries were the key force behind the record FDI flows, investing $270 billion (an increase of 42 per cent over 1994) and receiving $203 billion (53 per cent higher) (table 1). The spectacular growth of FDI among developed countries was accompanied by a

Table 2. Selected indicators of FDI and international production, 1986-1995

(Billions of dollars and percentage)

Item	Value at current prices, 1995[a] (*Billions of dollars*)	Annual growth rate (*Per cent*) 1986-1990	1991-1994
FDI inflows	315	24.7	12.7
FDI outward stock	2 730	19.8	8.8
Sales of foreign affiliates	6 022[b]	17.4	5.4[c]
Royalties and fees receipts	41[d]	21.8	10.1
GDP at factor cost	24 948[d]	10.8	4.3
Gross product of foreign affiliates	1 410[e]	11.0[f]	11.4[g]
Gross fixed capital formation	5 681[d]	10.6	4.0
Exports of goods and non-factor services	4 707[b]	14.3	3.8[c]

Source: UNCTAD, *World Investment Report 1996*, p. 5.

[a] Estimates.

[b] 1993.

[c] 1991-1993.

[d] 1994.

[e] 1991.

[f] 1982-1989.

[g] 1989-1991.

NOTE: Not included in this table are the value of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves.

hefty rise in flows into developing countries, which, at $100 billion, set another record in 1995; outward investment from developing countries also rose, reaching $47 billion. Investment flows to Central and Eastern Europe nearly doubled to $12 billion in 1995, after stagnating in 1994.

Investment flows are concentrated in a few countries. The ten largest host countries received two thirds of total inflows in 1995 and the smallest 100 recipient countries received only 1 per cent. Investment going to the top 10 host countries is also more important for their economies than it is for the bottom 100: the share of FDI stock in GDP for the smallest 100 recipients is below that of the top 10 recipients. In the case of outflows, the largest five home countries (the United States, Germany, the United Kingdom, Japan and France) accounted for about two thirds of all outflows in 1995.

Foreign direct investment is a major force shaping globalization. The outward FDI stock which the 39,000 or so parent firms invested in their approximately 270,000 foreign affiliates reached $2.7 trillion in 1995 (table 2).

Moreover, FDI flows doubled between 1980 and 1994 relative to both global gross fixed capital formation and world GDP. And the value added of all foreign affiliates accounted for 6 per cent of world GDP in 1991, compared with 2 per cent in 1982.

. . . aided by a boom in mergers and acquisitions, increasingly used as a corporate strategy . . .

The latest surge in FDI flows reflects the fact that an increasing number of firms, including those from developing countries, are becoming more active globally in response to competitive pressures, liberalization and the opening up of new areas for investment. These firms are once again using mergers and acquisitions (M & As) as a central corporate strategy for establishing production facilities abroad to protect, consolidate and advance their international competitiveness.

The value of all cross-border M & A transactions (including those involving portfolio investments) doubled between 1988 and 1995, to $229 billion. The value of majority-held M & A transactions (excluding those involving portfolio investment and minority-held FDI) increased by 84 per cent in 1988-1995, to $135 billion. In Western Europe—the focus of M & A activity in 1995—majority cross-border sales of firms were $50 billion and purchases were $66 billion. Much of that was due to intra-European Union deals. But the highest levels of M & A transactions in 1995—$49 billion worth of sales and $38 billion worth of purchases—were registered by the United States. Industries with high cross-border M & A activity include energy distribution, telecommunications, pharmaceuticals and financial services. There was also a notable increase in participation of small and medium-sized and services-related enterprises. Overall, the M & A boom that began in the late 1980s, but was dampened by the FDI recession of the early 1990s, helped FDI flows to rise to record heights in 1995.

. . . and is beginning to reflect the opening up of infrastructure to foreign participation

New investment opportunities in infrastructure, partly because of liberalization and deregulation and partly because governments turn more and more to foreign firms for capital and technology, have aided FDI to reach record levels. Infrastructure, especially communications, attracted FDI flows of around $7 billion annually in the early 1990s. This is but a fraction of the total investment requirements in infrastructure, much of which remains unmet.

Investment outflows to infrastructure from the major home countries made up 3-5 per cent of their total outflows in 1995. In many countries, FDI flows account for less than 1 per cent of the gross fixed capital formation in infrastructure. For the United States, the largest outward investor, the share of infrastructure industries in its outward FDI flows between 1992 and 1994 averaged 4.9 per cent a year. United States TNCs have invested $14 billion in infrastructure as of 1994, 2.3 per cent of its total outward stock. This share is small when compared with the share of FDI in infrastructure in 1940; then, more than a third of the United States FDI stock in Latin America was in infrastructure. Subsequent waves of nationalizations and expropriations, however, led to dramatic declines, a trend that has only recently begun to reverse.

The revitalized interest of TNCs in infrastructure has been sparked by several factors. Recognizing that shortfalls in infrastructure services can hamper economic development, more governments are willing to privatize and relinquish control of State monopolies to attract foreign investment and technology and to realize efficiency gains. Between 1988 and 1995, infrastructure privatizations mobilized private capital of nearly $40 billion, more than half of which was foreign direct and portfolio investment. Furthermore, technological developments, notably in telecommunications, have turned infrastructure industries previously dominated by natural monopolies into competitive industries with potentially profitable investment opportunities. Capital raised from public sources in many countries is no longer sufficient to meet the financing requirements of infrastructure development. Privately sourced capital, often mobilized by TNCs, has therefore stepped in to help meet those requirements, including through new techniques of financing projects such as build-operate-transfer, build-own-operate, and build-own-transfer schemes.

Despite the still low levels of FDI flows in infrastructure, future prospects for increased TNC involvement are promising. Despite their high fixed costs, many infrastructure projects are attractive to foreign investors. Continuing FDI liberalization and infrastructure deregulation, coupled with the growth of investment guarantees, helps to lower the risks of nationalization. Potential for greater TNC involvement in infrastructure is especially conducive to attracting FDI, such as the establishment of science parks, export-processing zones and facilities for human resource development.

The world's largest TNCs are becoming more transnational...

The world's largest 100 TNCs (excluding banking and financial institutions), ranked by foreign assets, are all based in developed countries (table 3). They have roughly $1.4 trillion worth of assets abroad and account for around a third of the global FDI stock. That share has remained stable in the past five years. Royal Dutch Shell (United Kingdom/Netherlands) has topped the list of the top 100 TNCs every year since 1990. A composite index of transnationality that takes foreign assets, foreign sales and foreign employment together, presents a different ranking of the top 100 TNCs: Royal Dutch Shell falls to twenty-seventh, and Thomson Corporation (Canada) climbs to first place.

Salient features of the top 100 TNCs are:

- By country of origin, United States TNCs (with 32 in the top 100) are the largest group ranked by share of foreign assets in total assets in 1994.

- Japanese TNCs are the fastest growing group among the top 100, increasing in number from 11 in 1990 to 19 in 1994. Japanese TNCs in electronics were amongst the most important new entrants.

- European TNCs are prominent in capital- and research and development-intensive industries, such as chemicals and pharmaceuticals.

- By industry, TNCs in chemicals and pharmaceuticals score the highest rankings in transnationality index, followed by firms in food and electronics. Trading firms score lowest.

The future investment plans of the top 100 TNCs suggest a strong upward trend in FDI (as well as total investment), fuelled partly by economic growth in major destinations, among which the developing countries are becoming more prominent. But intra-developed-country FDI will continue to feature prominently in future investments of the top 100. Transnational corporations based in North America view Europe as the most impor-

Table 3. The top 10 TNCs ranked by foreign assets, 1994

(Billions of dollars and number of employees)

Ranking by: Foreign assets	Index[b]	Corporation	Country	Industry[a]	Assets: Foreign	Assets: Total	Sales: Foreign	Sales: Total	Employment: Foreign	Employment: Total	Index[b]
1	27	Royal Dutch Shell[c]	United Kingdom/ Netherlands	Petroleum	63.7	102.0	51.1	94.8	79 000	106 000	63.6
2	80	Ford	United States	Motor vehicles and parts	60.6	219.4	38.1	128.4	96 726	337 778	28.6
3	26	Exxon	United States	Petroleum	56.2	87.9	72.3	113.9	55 000	86 000	63.8
4	85	General Motors	United States	Motor vehicles and parts	..[d]	198.6	44.0	152.2	177 730	692 800	25.7
5	38	IBM	United States	Computers	43.9	81.1	39.9	64.1	115 555	219 839	56.4
6	30	Volkswagen	Germany	Motor vehicles and parts	..[d]	52.4	29.0	49.3	96 545	242 318	60.4
7	97	General Electric	United States	Electronics	33.9	251.5	11.9	59.3	36 169	216 000	16.7
8	82	Toyota	Japan	Motor vehicles and parts	..[d]	116.8	37.2	91.3	27 567	172 675	28.1
9	59	Daimler-Benz	Germany	Transport and communication	27.9	66.5	46.3	74.0	79 297	330 551	42.8
10	37	Elf Aquitaine	France	Petroleum	..[d]	48.9	26.2	38.9	43 950	89 500	56.7

Source: UNCTAD, *World Investment Report 1996*, p. 30.

[a] Industry classification for companies follows that in the "Fortune Global 500" list in Fortune, 25 July 1994, and the "Fortune Global Service 500" list in Fortune, 22 August 1994. Fortune classifies companies according to the industry or service that represents the greatest volume of their sales. Industry groups are based on categories established by the United States Office of Management and Budget. Several companies are, however, highly diversified. These companies include Asea Brown Boveri, General Electric, Grand Metropolitan, Hanson, Sandoz, Total and Veba.

[b] The index of transnationality is calculated as the average of foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[c] Foreign sales are outside Europe whereas foreign employment figures are outside the United Kingdom and the Netherlands.

[d] Data on foreign assets are either suppressed to avoid disclosure or they are not available. In the case of non-availability, they are estimated on the basis of the ratio of foreign to total employment, foreign to total sales and similar ratios for the transnationality index.

tant future investment location, especially in high-technology and consumer-goods industries. Likewise, European TNCs see the United States as the most important location. Japanese TNCs, however, view Asia as the most promising. Transnational corporations from North America and Europe also have a positive view of Asia; this region is therefore expected to capture the largest growth of planned capital investments by the world's largest TNCs in the second half of the 1990s.

. . . and the largest developing-country TNCs are moving in the same direction

The 50 largest TNCs based in developing countries, ranked by foreign assets, accounted for about 10 per cent of the combined outward FDI stock of firms in their countries of origin. These firms' ratio of foreign to total sales is high (30 per cent), but their ratio of foreign to total assets (9 per cent) is low. Their overall index of transnationality (21 per cent) is low, compared with that of the world's top 100 TNCs (42 per cent), reflecting their short history as important outward investors; but their plans for expansion suggest that they will become increasingly more transnational.

In 1994, Daewoo (Republic of Korea) ranked first among the 50 largest TNCs from developing countries on the basis of the ratio of foreign to total assets (table 4). Mexico's Cemex, the top TNC among developing country firms in 1993, ranked third. On the basis of the transnationality index, Creative Technology (Singapore), a producer of standard personal computer sound systems that holds more than 60 per cent of the global market share, was in first place in 1994. By country of origin, TNCs from China and the Republic of Korea, with eight entries each, were the largest groups among the top 50 developing country TNCs ranked by foreign-to-total asset share. By industry, TNCs in construction and electronics had the highest rankings.

Led by the United States, developed countries experienced rapid growth of FDI flows in 1995, . . .

Almost 90 per cent of the 1995 increases in FDI inflows (and outflows) were registered by developed countries. Because of this, the share of developed countries in world inflows increased from 59 per cent in 1994 to 65 per cent in 1995, while outflows rose from 83 to 85 per cent. The growth

Table 4. The top 10 TNCs base om developing economies, ranked by foreign assets, 1994

(Billions of dollars and number of employees)

Ranking by: Foreign assets	Index[a]	Corporation	Country	Industry	Foreign Assets	Total Assets	Foreign Sales	Total Sales	Foreign Employment	Total Employment	Index[a]
1	11	Daewoo	Korea, Republic of[b]	Electronics	..[c]	33 000	16 000	40 000	100 000	200 000	33.0
2	10	Hutchison Whampoa Limited	Hong Kong	Diversified	..[c]	52 192	12 500	30 168	15 086	26 855	34.4
3	8	Cemex S. A.	Mexico	Cement	2 847	7 893	744	2 101	8 073	20 997	36.6
4	5	Jardine Matheson Holdings Limited[d]	Hong Kong	Construction	2 539	6 350	6 463	9 559	50 000	220 000	43.4
5	..	China State Construction Engineering orp.	China	Construction	2 189		..[e]	1 010	..[e]	..[f]	..[e]..
6	..	China Chemicals Imports & Exports	China	Trading	1 915		..[e]	7 914	..[e]	..[f]	..[e]..
7	20	Samsung Co., Ltd.	Korea, Republic of[b]	Electronics	..[c]	38 000	21 440	67 000	42 235	195 429	19.5
8	17	LG Group	Korea, Republic of[b]	Electronics	..[c]	25 000	8 600	43 000	29 061	59 200	25.1
9	19	Grupo Televisa S. A.	Mexico	Media	1 371	3 260	286	1 288	..[f]	21 600	22.2
10	34	Hyundai	Korea, Republic of[b]	Diversified	1 293	9 657	1 610	13 081	814	44 835	9.2

Source: UNCTAD, *World Investment Report 1996*, p. 34.

[a] The index of transnationality is calculated as the average of foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

[b] The accounting standards of the Republic of Korea do not require the publication of consolidated financial statements including both domestic and foreign affiliates. The figures provided here are estimates of consolidated financial statements as provided by the companies in response to a survey by UNCTAD. Depending on the availability of the data on foreign components, the data for business group totals are used.

[c] Data on foreign assets are either suppressed to avoid disclosure or they are not available. In the case of non-availability, they are estimated on the basis of the ratio of foreign to total employment, foreign to total sales and similar ratios for the transnationality index.

[d] A subsidiary of Jardine Matheson Holdings of Bermuda.

[e] Data are not available.

[f] Date on foreign employment are suppressed to avoid disclosure or not available. In the case of non-availability of the data, they are estimated on the basis of other foreign component ratios for the transnationality index.

of developed country FDI was led by a few countries—the United States, the United Kingdom, France and Australia, in that order, in the case of inflows, and the United States, the United Kingdom and Germany, in that order, in the case of outflows.

With large increases in inflows and outflows in 1995, the United States strengthened its position as the largest host and home country. With $60 billion, United States inflows were twice that of the United Kingdom, the second largest recipient among developed countries. Reflecting high levels of M & A-related investment by Western European TNCs, led by the United Kingdom and Germany, equity flows into the United States rose by 50 per cent. Reinvested earnings and intra-company loans (the other components of FDI) increased by 78 per cent and 36 per cent, respectively. Likewise, the $95 billion worth of United States outflows in 1995 reflected both record equity capital flows ($42 billion) and record reinvested earnings ($42 billion); 54 per cent of these outflows went to Western Europe.

The United Kingdom and Germany also registered record outflows in 1995, $38 billion and $36 billion, respectively. Large-scale investments in the markets for its main exports (the European Union and the United States) characterized FDI from the United Kingdom. German TNCs directed their attention to investment opportunities abroad, partly to escape cost increases and currency appreciations at home and partly because investments in the eastern part of the country have abated with the completion of the privatization programme.

Increases of 20 per cent in 1994 and 15 per cent in 1995 are strong signs that Japanese FDI outflows are recovering. Japanese TNCs are investing abroad faster than at home. However, 1995 FDI outflows were still less than half of the annual average in 1989-1991. Most Japanese FDI goes to East and South-East Asia and developed countries, and is aimed at establishing regional or global networks (efficiency-seeking FDI) or supplying local markets. Investment flows to Africa and Central and Eastern Europe have been small, accounting for only 0.1 per cent and 0.3 per cent of Japan's total outflows, respectively, in 1990-1994. To recover and increase their international competitiveness, Japanese affiliates are establishing "second generation" affiliates abroad. For example, 47 per cent of Japanese affiliates in Hong Kong, and 43 per cent of Japanese affiliates in Singapore, have already established their own foreign affiliates.

. . . while flows to developing countries advanced, and those to developing Asia boomed

The current boom in FDI flows to developing countries, with inflows reaching $100 billion in 1995, is a reflection of sustained economic growth and continuing liberalization and privatization in these countries, as well as their increasing integration into the investment plans of TNCs. The share of developing countries in the combined outflows of the largest five developed-country outward investors rose from 18 per cent in 1990-1992 to 28 per cent in 1993-1994. Investment from developing countries to other developing countries is also increasing: in 1994, for example, more than half of the FDI flows from Asian developing countries were invested in the same region.

South, East and South-East Asia continued to be the largest host developing region, with an estimated $65 billion of inflows in 1995, accounting for two thirds of all developing-country FDI inflows. The size and dynamism of developing Asia have made it increasingly important for TNCs from all countries to service rapidly expanding markets, or to tap the tangible and intangible resources of that region for global production networks. European Union TNCs, in particular, after neglecting Asia in the past, are now changing course and investing more.

China has been the largest developing-country recipient since 1992. Although inflows are soaring in other countries as well, with 58 per cent of inflows to South, East and South-East Asia in 1995, China has been the principal drive behind Asia's current investment boom. Recent FDI policy changes in China may dampen these flows temporarily, however. China is moving towards national treatment, eliminating gradually some preferences for foreign investors, such as exemptions from import duties, that have distorted markets, encouraged "round-tripping", speculative investments and "phantom" foreign ventures. However, given China's outstanding growth performance and the continued opening of new areas to FDI, such as infrastructure, its attractiveness to foreign investors is unlikely to be affected seriously. Hence, Asia's investment boom will probably be sustained in the coming years.

Investment flows to Latin America and the Caribbean have risen, but continue to be "lumpy" . . .

Latin America and the Caribbean saw a 5 per cent increase of FDI inflows to $27 billion in 1995. Most, however, were concentrated in individual industries (automobiles in Mexico and Brazil, natural resources in Chile) or privatization-induced (in Argentina and Peru). Investment flows in Latin American countries are therefore susceptible to special circumstances in those industries or to privatization policies. Especially at the country level, investment flows are prone to wide year-to-year fluctuations which make them "lumpy".

Argentina, Peru and Venezuela provide illustrations of lumpiness in FDI: when some large companies were privatized in the early 1990s, investment inflows soared. In the following years, however, they fell considerably, which was only partially offset by post-privatization investments. Investments in large mining projects or in industries such as automobile manufacturing may also cause "spikes" in FDI flows and lead to lumpiness. Lumpy FDI flows cannot only change drastically the ranking of FDI recipients from one year to the next, but also the industrial composition of investment flows for a given country. For example, in Peru, communication and transport accounted for 42 per cent of its 1995 inward FDI stock, compared with 0.4 per cent in 1990; the "spike" in 1995 was the result of a large telecommunications privatization. With large-scale privatizations beginning to be implemented in Brazil and with the launching of large investment projects in automobiles, lumpy FDI will continue to shape the level and composition of flows to Latin American countries for some years.

. . . *while Africa remains marginalized . . .*

The FDI stock in Africa doubled between 1985 and 1995. Inflows to Africa, however, have not been rising as rapidly as inflows to other regions. In 1995, they were almost the same as in 1994—$5 billion. The share of Africa in developing-country inflows therefore fell to 4.7 per cent in 1995 (from 5.8 per cent in 1994). But within Africa, there have been significant changes in the geographic pattern of FDI. In the 1980s, southern Africa accounted for more than 40 per cent of Africa's FDI stock, but its importance has diminished substantially since, and by 1993 it accounted for about a quarter of Africa's stock. In contrast, North African countries, which in 1980 accounted for a mere 12 per cent of total stock in Africa, have substantially improved their position, accounting for more than 30 per cent by 1993, due mainly to the rising levels of European investments. Investors from the developed countries have displayed uneven interest in Africa. Due to geographical proximity and post-colonial ties, Western European investors have always been more active compared with both United States and

Japanese investors. Within Western Europe, France, Germany, Italy and the United Kingdom are the main investors in Africa.

Significant variations exist in the importance of FDI for Africa's recipient countries. For countries with large inflows, such as Nigeria, FDI is not as significant relative to the size of the domestic economy as it is for countries with small flows, such as Equatorial Guinea.

. . . and Central and Eastern Europe sees a surge in response to economic recovery

Driven not only by waves of privatizations, but by economic recovery in some countries (Poland and the Czech Republic), FDI inflows to Central and Eastern Europe have soared to record levels. Having remained stagnant in 1994, inflows almost doubled in 1995, to reach an estimated $12 billion. The region accounted for 5 per cent of world inflows in 1995, compared with only 1 per cent in 1991. Hungary and the Czech Republic accounted for about two thirds of the increase in 1995, with inflows tripling to $3.5 billion and $2.5 billion, respectively. The 1995 FDI flows into the Russian Federation at an estimated $2 billion were double the 1994 level.

A significant share of the FDI received by Central and Eastern European economies—18 per cent in 1994—is from privatization of State enterprises. However, this share has declined considerably compared with 1989-1993 when, for the main recipient countries (excluding the Russian Federation), privatization-related inflows accounted for most FDI. The trend in FDI inflows and, in particular, non-privatization related FDI inflows, is correlated with the growth of domestic output: in most countries, FDI inflows picked up when GDP growth became positive. Thus, while many foreign investors rushed to establish a nominal presence in Central and Eastern Europe as countries began to liberalize their investment frameworks in the late 1980s and early 1990s, it was only when transition was well under way and negative growth rates of GDP began to reverse that TNCs began to invest significantly. The doubling of FDI into the region in 1995 reflects the recognition by TNCs that Central and Eastern European countries, particularly those in Central Europe, are well on the way to becoming market economies.

Foreign direct investment and trade: interlinkages and policy implications

The rapid growth of FDI and discussions about international arrangements related to such investment have drawn renewed attention to the relationship between trade and FDI. Does trade lead to FDI or FDI lead to trade? Does FDI substitute for trade or trade substitute for FDI? Do they complement each other? In other words, what does the growth of FDI mean for trade and—most importantly—what are the implications for growth and development?

Since FDI and trade are both handmaidens of growth and development, it is important to understand the interlinkages between the two

Foreign direct investment and trade are of importance for economic performance, growth and development. They are, moreover, increasingly interrelated. These interlinkages are important for several reasons:

- The role of trade as a positive factor in growth and development has long been recognized and reflected in trade policies. Foreign direct investment, as the principal method of delivering goods and services to foreign markets and the principal factor in the organization of international production, increasingly influences the size, direction and composition of world trade, as do FDI policies.

- The role of FDI as a positive factor in growth and development is being increasingly appreciated and is also increasingly reflected in FDI policies. Trade and trade policies can exert various influences on the size, direction and composition of FDI flows.

- Apart from the autonomous impacts of each on growth and development, interlinkages between trade and FDI must be taken into account if the developmental contribution of each is to be maximized, and if synergies between the two and broader growth and development objectives are to be maximized.

These considerations provide good reasons for looking more closely at the nature of the interlinkages between FDI and trade. Another reason is that national FDI and trade policies are generally formulated independently of each other, with the result that the two sets of policies may not always fully support one another in policy objectives and their efficient implementation. An improved understanding of the interlinkages can contribute to the formulation of national policies in the two areas that are mutually supportive. And, of course, it would also provide a background and basis for discussions at the international level as regards appropriate policy arrangements.

The relationship between trade and FDI in a given product is characterized by a sequential process of internationalization . . .

Historically, the relationship between FDI and trade for a given product has been characterized by a linear, step-by-step sequential process of internationalization, running from trade to FDI or from FDI to trade.

In manufacturing, market-seeking firms typically begin with domestic production and sales. They internationalize via export, licensing and other contractual arrangements and by establishing foreign trading affiliates before they engage in FDI. As a result of this linear sequence, FDI in manufacturing is often viewed as an activity replacing trade. This perception has been strengthened, moreover, by the notion of a product cycle in which FDI takes place only when an innovating firm no longer finds exporting as profitable as producing abroad. This sequence of trade leading to FDI characterizes internationalization that is motivated by the search for markets, traditionally the dominant factor motivating TNCs. Manufacturing firms that seek low-cost inputs (especially labour), as part of their effort to improve efficiency and corporate performance may, however, begin their internationalization sequence with FDI, and this is trade creating.

The dominant characteristic of the relationship between trade and FDI in the natural resources sector is also a linear progression from one to another. It begins either with imports, followed by FDI from the importing country in a process of vertical integràtion that may well lead to higher exports from the host country, or it begins with resource-seeking firms undertaking FDI and proceeding to export from host countries. The latter, common in non-renewable resources, accounts for most natural resource investments. In both cases, FDI is typically trade creating, leading to exports or additional exports from the host country.

In the services sector, the dominant characteristic is that trade as an option to deliver many services abroad does not exist, and firms must move directly to foreign production if they want to satisfy international market demand. As a result, service firms do not enjoy the comfort of a gradual conquest of foreign markets through a linear sequential approach: the linear sequence is truncated. The need for local presence to deliver services is one reason underlying the shift of the world FDI stock towards services in the past 20 years. Establishing affiliates abroad has, in general, a smaller direct impact on home country exports of the service in question than establishing market-seeking manufacturing affiliates has on trade in a product.

The situation as regards FDI and trade in services is beginning to change under the impact of the growing transportability of services, and especially that of information-intensive services, or parts thereof, due to advances in telecommunications and information technologies. This may reduce the need for FDI to deliver these services to foreign markets. The technological advances that have increased tradability have also opened up possibilities for export-oriented FDI in some services or as regards particular services functions undertaken typically in-house by various firms (e.g. data processing, accounting).

. . . with associated trade and associated investment effects . . .

Apart from product-specific FDI and trade impacts of sequential trade-FDI interlinkages, there are also impacts from associated trade and associated FDI. The former include, for example, additions to exports of the home country due to intra-firm sales of services and intangible assets by parent firms to foreign affiliates, whether in manufacturing, natural resources or services. They also include additions to home country exports due to intra-firm sales of machinery and intermediate products by parent firms to their foreign affiliates. Similar exports from the parent firm occur in low-cost input-seeking manufacturing FDI and in natural resource FDI. In addition, there could be further effects on trade due to exports by other firms in the same or other industries (or even sectors) of goods and services required by foreign affiliates.

Foreign affiliates in the services sector may also have an indirect impact on trade, as they may create demand for necessary machinery and equipment and/or for information-intensive support services provided either by headquarters personnel or services provided via communication lines. But again, this impact is not large. The exception is FDI in trading services, which plays a substantial role in facilitating the exports of goods from home or host countries, or both.

The internationalization sequence in a given product also gives rise to associated FDI. This begins when, for example, a firm exporting a manufactured product establishes marketing or other affiliates abroad; it continues when other firms (e.g. component suppliers, advertising firms, banks, insurance companies) follow suit once an investment in a particular product has been made. In natural resources, associated FDI can take place where certain services are required (e.g. shipping) or where foreign firms move into processing. Investment in a service may lead to the establishment of foreign affiliates in related services. More importantly, FDI in trading services can give rise to associated FDI in the production of manufactured and primary products by the same TNC or other TNCs.

. . . and implications for countries' trade

The overall impact of market-seeking direct investment on the volume and composition of trade of a home or host country at the industry or aggregate level depends on the relative importance of these various direct and indirect effects. In general, FDI that follows trade can replace trade in a single product, but it is unlikely to do so—and, in fact, is often complementary to trade—at the sectoral and national levels. Some empirical studies suggest, indeed, that the trade-creating effect of FDI in manufacturing tends to outweigh the trade-replacing effect for the home country. Moreover, FDI seems to shift the composition of home country exports to host countries towards intermediate products and away from final products.

In natural resources, the impact of the FDI trade linkage was, and still is, trade creating. For one thing, host country exports of the resources involved expand. So do, generally, home country imports of the same resources and, also often, home country net exports due to increased exports of the resources after processing, or of manufactured goods based on these resources. The principal issues regarding this FDI-trade interlinkage relate to the retained value (or share of rents) accruing from the exploitation of, and trade in, host country resources and the role that these resources can (or should) play in development. Many countries had severed the FDI-trade linkage through nationalizations, in the expectation that they could capture a larger share of the rents and promote domestic development more effectively. More recently, a new relationship appears to have emerged in which many countries benefit from trade, technology and skill assets that TNCs possess, and firms benefit from stable supplies, without necessarily risking their capital. Still, TNCs account for a fair share of the raw material trade of host countries. In 1992, United States affiliates alone accounted for one tenth of all raw material exported from both developed and developing host countries. This share is double that of the mid-1960s for all developed countries, and half that for developing countries.

Since the links between FDI and trade in services are limited, the effects of FDI on host developing countries are largely independent from, rather than intertwined with, those of trade. As the tradability of some services increases, however, host countries, including developing countries, are able to participate more in the production and export of these services. This might, however, be accompanied by reduced technology transfer and skills development, as compared with the levels that TNCs traditionally have had to undertake for stand-alone service affiliates to function effectively.

Although the distinct characteristics of the FDI-trade relationship in the three sectors make it easier to understand the interlinkages between FDI and trade, the intersectoral nature of interlinkages in reality must be emphasized. Many firms not only perform various activities but produce both goods and services, so that classifying them sectorally is an oversimplification. Moreover, associated trade and associated investment effects of internationalization through trade on FDI are often intersectoral. The crossing of sectoral boundaries, both in the framework of a single firm's activities and as regards indirect FDI and trade effects, makes it increasingly difficult to isolate separate trade and investment effects associated with the internationalization sequence of a particular product, firm or, indeed, industry or sector.

But what seems to be clear is that, first, trade eventually leads to FDI; and, secondly, on balance, FDI leads to more trade. The result, therefore, is an intensification of international economic interactions.

The world environment for trade and FDI is changing, . . .

The linear interrelationship between trade and investment continues to characterize a good part of FDI. But something new is happening. In the past 30 years or so, and particularly since the mid-1980s, the environment for FDI and trade has changed significantly. The most important changes relate to the reduction of technological and policy-related barriers to the movement of goods, services, capital, professional and skilled workers, and firms. More specifically, technological developments have greatly enhanced the ease with which goods, services, intangible assets and people can be transported, and tasks related to the organization and management of firms implemented over distances. The liberalization of rules and regulations governing trade, investment and technology flows has meant that the new possibilities created by technology can actually be realized. As a result, international production has grown substantially, as many firms have become TNCs. For example, the number of parent firms headquartered in 15 major developed home countries nearly quadrupled between 1968/1969 and 1993, from 7,000 to 27,000. Thus, there is a substantial presence of foreign affiliates in the world economy today. While most are largely stand-alone affiliates, more are being drawn into closer interaction with each other.

. . . allowing firms greater choice of production locations and modalities of internationalization, making the internationalization sequence less important . . .

The principal effect of the new environment is that firms are freer to choose how to serve foreign markets: by producing at home and exporting, by producing in a foreign country for local sale, or by producing in a foreign country for export. They also have greater freedom to obtain foreign resources and inputs for production by importing them from foreign producers or by establishing production facilities that enable them to access resources where they are located, for producing raw, intermediate or final products for use elsewhere or sale in national, regional or global markets.

With competition driving firms to use the new possibilities to an increasing extent, more firms, especially in technologically sophisticated industries, immediately look at regional or world markets. Established TNCs in manufacturing and services in particular, can jump over the earlier steps directly to the FDI stage. Moreover, the internationalization sequence leading to FDI can begin anywhere within a TNC system—innovation, the production of a new good and export can start in a foreign affiliate rather than the parent firm.

. . . and pushing TNCs to establish integrated international production systems, . . .

But the changes brought about by the new environment go further. As firms seize new regional and global opportunities, they combine ownership advantages with the locational advantages of host countries, and so strengthen their own competitive positions. With this purpose in view, firms—particularly those that are already TNCs—are increasingly organizing or reorganizing their cross-border production activities in an efficiency-oriented, integrated fashion, capitalizing on the tangible and intangible assets available throughout the corporate system. In the resulting international division of labour within firms, any part of the value-added chain can be located wherever it contributes most to a company's overall performance.

As a result, the simple, sequential relationship characteristic of TNCs in manufacturing gives way to a more complex relationship, in which intra-firm trade flows between parent firms and affiliates and among affiliates assume considerable and increasing importance. This is reflected, for example, in the increase in the share of intra-firm trade in total trade of United States TNC parent firms, as well as foreign affiliates, in 1983-1993. The high share of affiliate-to-affiliate trade in intra-firm trade by United States affiliates, and its growth, particularly in developing countries, are also striking. The share of exports to other foreign affiliates in intra-firm exports of foreign affiliates rose from 37 per cent in 1977 to 53 per cent in 1983 and to 60 per cent in 1993. A greater division of labour within TNCs, through either horizontal or vertical integration of activities dispersed among different locations, necessarily increases intra-firm investment and trade flows. Moreover, since the trade flows generated by integrated international production systems are related to the vertical or horizontal integration of production activities (or both), the structure of trade linked to such FDI involves relatively larger shares of intermediate products and services and intra-industry trade.

Nowhere can the difference that the new environment can make with respect to FDI-trade interlinkages be seen more clearly than in the European Union and in the contrasting experiences of Asia and Latin America. In the European Union, the share of exports relative to sales of United States affiliates to other (mostly European Union) destinations increased noticeably as a result of the restructuring of TNC activities to take advantage of European integration, from 14 per cent in 1957 to 31 per cent in 1993. In East and South-East Asia, export propensities of United States affiliates have been high since the 1960s, reflecting the integration of the former into the global division of labour by United States TNCs in electronics and other industries. In contrast, export propensities of United States affiliates in Latin America were traditionally much lower. However, when countries in this region began to liberalize their trade policies in the mid-1980s, export propensities rose faster than those in Asia (table 5).

Table 5. Export propensities of United States majority-owned foreign affiliates in manufacturing, 1966-1993[a]

(Percentage)

	1966	1977	1982	1986	1989	1993
All economies[b]	18.6	30.8	33.9	38.4	37.8	40.3
Developed economies[c]	20.4	33.1	36.6	39.3	38.0[c]	40.6
Developing economies[c]	8.4	18.1	22.0	32.5	36.7[c]	38.7
Latin America and the Caribbean	6.2	9.7	11.9	20.0	22.0	22.2
Brazil	3.0	8.9	12.4	16.9	16.4	17.0
Mexico[c]	3.2	10.4	10.8	34.5	33.7	32.1
Developing Asia[c]	23.1	57.0	60.6[c]	67.5[c]	64.4	64.4
India	6.9	3.6	..	4.1	..	..
Malaysia	..	76.2	81.5	83.7	74.7	84.9
Philippines	19.9	25.7	26.5	39.4	33.7	37.3
Thailand	..	38.0	..	58.5	73.3	61.2
Newly industrializing economies	..	81.2	76.0[c]	76.2[c]	67.9	67.0
Hong Kong	..	80.5	77.4	71.8	68.6	55.0
Republic of Korea	..	68.4	..	58.0	38.5	27.9
Singapore	..	93.2	91.8	89.7	87.2	85.9
Taiwan Province of China	..	71.4	59.4	63.7	46.4	38.8

Source: UNCTAD, *World Investment Report 1996*, p. 110.

[a] Exports (total sales minus local sales or sales to the United States plus sales to other countries) as per cent of total sales.

[b] Developed and developing economies.

[c] Exports by manufacturing affiliates in Africa and the Republic of Korea in 1982, Africa and the Middle East in 1986 and Israel and New Zealand in 1989 and 1993, included in these figures, are estimates.

. . . within which FDI and trade flows are determined simultaneously

The decision to locate any part of the value-added chain wherever it is best for a firm—be it transnational or national—to convert global inputs into outputs for global markets means that FDI and trade flows are determined simultaneously. They are both immediate consequences of the same locational decision.

As a result, the issue is no longer whether trade leads to FDI or FDI to trade; whether FDI substitutes for trade or trade substitutes for FDI; or whether they complement each other. Rather, it is: how do firms access resources—wherever they are located—in the interest of organizing production as profitably as possible for the national, regional or global markets they wish to serve? In other words, the issue becomes: where do firms locate their value-added activities? In these circumstances, the decision where to locate is a decision where to invest and from where to trade. And it becomes an FDI decision, if a foreign location is chosen. It follows that, increasingly, what matters are the factors that make particular locations advantageous for particular activities, for both, domestic *and* foreign investors.

This creates new opportunities and challenges for countries

Reduced obstacles to trade and FDI and the possibilities that they open up for TNCs to disperse production activities within integrated international production systems create new opportunities for countries. The challenge is to attract FDI and then to maximize the benefits associated with it in order to realize the opportunities arising from the new environment.

For example, integrating production within corporate systems along efficiency-oriented lines means that firms fragment activities more closely—and narrowly—in accordance with the static comparative advantages of different (domestic and foreign) locations. The division of labour that results provides potential opportunities for countries to participate in production and trade associated with TNCs, specializing in segments of goods and services production for which they have a comparative advantage. Moreover, as firms fine-tune their search for locational advantages, countries with a broad range of capabilities have the opportunity to attract specialized activities in various industries. Many firms in developing countries, particularly in Asia, but also in Latin America, are already part of regionally or globally integrated production systems of TNCs or are linked to them through subcontracting or other arrangements, exporting parts, components and/or selected products to affiliates and parent companies. There are, of course, always risks associated with participation in the international division of labour. Vulnerability may increase as specialization becomes more narrow, especially when it is susceptible to technological change and locational reorientation (e.g. data processing).

Greater interconnectedness of FDI and trade also has potential implications for dynamic change and growth through technological upgrading and innovation in the countries attracting TNCs. As the international intra-firm division of labour within TNCs evolves, affiliates become focused on areas in which the local potential for innovation is greatest. Hence, there is a search for local sources of innovation in each affiliate, which can become part of a regional or global strategy of production and marketing. For developing countries, the extent to which the gains from participating in such integrated innovation within TNC systems are realized locally depends on the role assigned to local affiliates and on the extent to which this role is associated with networking with other firms (especially indigenous firms) in the same location, and hence becomes part of a wider system of technological and associated spillovers. Countries differ considerably in how they can act as centres of excellence for FDI in research-based products. A few developing countries have succeeded in becoming centres for the location of innovative activities of TNCs and have become locked into a dynamic process of technological upgrading. Others have not managed to attract FDI that carries technological spillovers and, therefore, have been locked out. This is precisely where government policies become important in terms of creating the factors that make a particular location attractive for particular activities, or in exploring alternative (non-TNC-related) avenues of dynamic upgrading.

There may also be benefits to countries due to the accelerated transformation of the industrial structures of host and home countries which is the allied consequence of the integration of FDI and trade. In general, countries—developed and developing—tend to benefit in efficiency from a restructuring in favour of industries in which the country is comparatively advantaged (and in which integrating TNCs expand their local operations), and in dynamic terms from a greater focus on activities in those industries in which the country's potential for innovation is greatest. For developing countries, the latter is particularly beneficial since foreign affiliates within those industries tend to develop greater capabilities as part of the regional or global strategies of their respective TNCs. Thus, these affiliates can make a greater contribution to local innovation through linkages and spillovers. However, the structural transformation that occurs because of opportunities created by integrated FDI and trade networks depends on local specificities. Many developing countries that have managed to attract FDI that is part of regionally or globally integrated production systems are involved in low-technology activities which have contributed to expanding and diversifying their economies, but which have limited consequences for technological upgrading. For a few, however, there has been more positive change.

From a wider perspective, the benefits of closer FDI-trade interlinkages—whether for static efficiency, technological dynamism or industrial restructuring—are by no means evenly distributed between countries, in part because of the uneven distribution of FDI. In the short and medium term, poorer countries that generally attract little FDI may have few opportunities to capture such gains and may indeed be further marginalized unless there are strong national and international efforts for development. As more countries build up the human-resource and infrastructure capabilities that TNCs seek, the scope for these countries to share in the benefits can be expected to increase. The gains of greater participation in the international division of labour are also accompanied by costs to particular groups within economies, both developed and developing—and more so when unemployment is high. Balancing the benefits against these costs poses a formidable challenge for policy makers.

Integrated FDI and trade requires coordinated policies

The intertwining of FDI and trade presents new challenges for national policy makers. The need for coordinated policy approaches acquires greater importance with the emergence of integrated international production systems, as investment and trade flows are the lifeblood of such systems. Transnational corporations internally integrate the trade and investment functions that most national governments still tend to view and address separately, sometimes creating a disjunction between national policy instruments and integrated corporate transactions. National trade and FDI policies have typically evolved separately, frequently influenced by different goals, and administered by distinct, often loosely connected agencies. This historical and organizational separation is not suited to a world in which trade and FDI are closely interlinked. Inconsistent policies risk creating an environment in which trade and FDI policies may neutralize each other, or could even prove counterproductive. On the other hand, when formulated and implemented coherently, national trade and FDI policies become mutually reinforcing in support of national growth and development. Coordination can generate synergies that yield outcomes exceeding the expectations for separate policy choices. At the same time, policy coherence does not presuppose any particular overall policy approach (e.g. a liberal approach); it is merely a reflection of the fact that, since FDI and trade are inextricably intertwined, national policies on FDI and trade need to be coordinated.

Towards a multilateral framework for foreign direct investment?

The question of international arrangements governing FDI is now prominent on the international agenda . . .

Foreign direct investment and trade are inextricably intertwined, both at the microeconomic level of firms' strategies and operations and at the macroeconomic level of national economies. They contribute not only individually and directly to the development process, but also jointly and indirectly, through linkages with one another. Governments are increasingly establishing national policy frameworks to create a framework within which FDI and trade can flourish, knowing full well that, once an appropriate enabling framework is created, other factors determine FDI and trade flows.

The principal manner in which governments are pursuing this objective *vis-à-vis* FDI regimes is through liberalization. They reduce restrictive investment measures; strengthen standards of treatment; provide investment protection; and pay more attention to ensuring the proper functioning of the market. In 1995 alone, 106 of 112 regulatory changes in 64 countries that altered investment regimes were in the direction of greater liberalization or the promotion of FDI (table 6).

Table 6. Regulatory changes, 1991-1995

(Number)

Item	1991	1992	1993	1994	1995
Number of countries that introduced changes in their investment regimes	35	43	57	49	64
Number of changes	82	79	102	110	112
Of which:					
In the direction of liberalization or promotion[a]	80	79	101	108	106
In the direction of control	2	-	1	2	6

Source: UNCTAD, *World Investment Report 1996*, p. 132.

[a] Including measures aimed at strengthening market supervision, as well as incentives.

Despite these significant changes, the question has been raised whether current international arrangements have been overtaken by global economic reality and, therefore, a ''catching up with the market'' is necessary. The vigorous growth of bilateral and regional investment agreements, the inclusion of certain FDI-related issues in the Uruguay Round agreements and the beginning of negotiations on a Multilateral Agreement on Investment in OECD suggest that many governments believe that this is, indeed, the case. Some governments—but also TNCs, as well as labour organizations, consumer groups and other non-governmental organizations, all for their own reasons—are driving the process, though, of course, there exists a diversity of views and approaches among these groups as to how international arrangements guiding FDI should be further developed.

. . . and is being pursued at the bilateral, . . .

At the bilateral level, key investment concepts, principles and standards have been developed through the conclusion of treaties for the protection and promotion of FDI (bilateral investment treaties or BITs). Their distinctive feature is their exclusive concern with investment. Introduced years ago, these treaties have remained virtually unchanged in their format, and the issues they address continue to be among the most important for investors. They contain mostly general standards of treatment after entry and establishment and specific protection standards on particular key issues. As far as development is concerned, BITs emphasize the importance of FDI for development and therefore seek to promote it; they generally recognize the effect of national laws and policies on FDI; and they contain various exceptions or qualifications, e.g. exceptions for balance-of-payments considerations in relation to the principle of free transfer of funds.

The network of BITs is expanding constantly. Some two thirds of the nearly 1,160 treaties existing in June 1996 were concluded in the 1990s (172 in 1995 alone), involving 158 countries. Originally concluded between developed and developing countries, recently more BITs are between developed countries and economies in transition, between developing countries, and between developing countries and economies in transition.

. . . regional . . .

At the regional level, the mix of investment issues covered is broader than that found at the bilateral level, and the operational approaches to deal with them are less uniform. This reflects, among other things, differences in interests and needs, levels of development, perspectives of future development and that investment issues are typically only one of the issues covered in a regional agreement. Most regional instruments are legally binding, although there are exceptions and the definition of investment varies considerably, depending on the purpose and context of an agreement.

Issues typically (though by no means uniformly) dealt with at the regional level include the liberalization of investment measures; standards of treatment; protection of investments and dispute settlement; and issues related to the conduct of foreign investors, e.g. illicit payments, restrictive business practices, disclosure of information, transfer pricing, environmental protection, and employment and labour relations. Where the question of providing special treatment to certain partners on account of different levels of development arises, it is dealt with primarily through exceptions, derogations, safeguards and the phasing of commitments.

. . . and, in partial ways, the multilateral levels

At the multilateral level, most agreements relate to sectoral or to specific issues, moving in on central FDI concerns from the outside. Particularly important among them are services, performance requirements, intellectual property rights, insurance, settlement of disputes and employment and labour relations. Attention is also being paid to restrictive business practices, competition policy, incentives and consumer protection.

It is at the multilateral level that concern for development is most apparent. This is particularly so in the case of the GATS, TRIPS and TRIMs agreements, as well as the (non-binding) Restrictive Business Practices Set, where special provisions are made that explicitly recognize the needs of developing countries.

Lessons can be learned from past efforts, including that the evolution of international arrangements for FDI has followed and interacted with developments at the national level and reflects the priorities and concerns of a particular period, . . .

In the 1980s, the earlier post-war approaches to investment, which often stressed restrictions, controls and conditions on entry and establishment of FDI, were reversed, mainly as a result of the debt crisis (which made FDI a more desirable alternative to bank lending) and of the changing perceptions of the role that FDI can play in growth and development. As a result, laws and policies in many developing countries began to change dramatically in the direction of liberalization, protection and promotion of FDI. Liberalization also expanded and deepened in developed countries. These changes are now being reflected in regional instruments, and in sectoral or issue-specific multilateral agreements.

Two lessons can be drawn from past pendular swings on FDI policies. One is that progress in the development of international investment rules is linked to the convergence of rules adopted by individual countries. The other is that an approach to FDI issues that takes into account the interests of all parties, and hence is to their common advantage, is more likely to gain widespread acceptance and, ultimately, to be more effective. In practice, this raises the question of how an appropriate balance of rights and obligations among affected actors can be found.

. . . that widespread recognition is emerging on the principal issues that need to be addressed in the FDI area, . . .

With the growing appreciation of the role of FDI in development and the convergence of national attitudes in favour of market-oriented policies, some issues have moved from the national to the international arena and have become standard substantive items in international discussions on FDI (even though the extent to which these are at present incorporated in specific international instruments varies considerably, as does the strength with which they are addressed). These include (but are not necessarily limited to) general standards of treatment of foreign investors; questions relating to entry and establishment and operational conditions; protection standards, including dispute settlement; issues relating to corporate behaviour; and other issues, such as the promotion of FDI.

In a rapidly globalizing world economy, the list of substantive issues entering international FDI discussions is becoming increasingly broader and may eventually include the entire range of questions concerning factor mobility. Issues that receive relatively little attention at this time may, therefore, acquire increased importance in the future.

. . . that, so far, progress has been made gradually, helped by increasingly greater transparency and monitoring, . . .

Regarding the functional characteristics of present arrangements, there are, with many variations, also some common features. Thus, restrictions are eliminated gradually (in the case of OECD, for example, it took 25 years from the adoption of the Liberalization Codes until the right of establishment was confirmed). Transparency is increased through the reporting of investment measures, and relevant normative changes and monitoring, follow-up and dispute-settlement mechanisms of varying degrees of strength and binding force are set up. A key lesson from these functional approaches is that implementing and strengthening standards are a lengthy process. But it may well be that globalization pressures and changing corporate strategies will require faster normative responsiveness in the future.

. . . that the interrelations between investment and trade are seen increasingly in a common framework, . . .

The Uruguay Round of Multilateral Trade Negotiations was the first time that some investment issues were directly introduced as part of the disciplines of the multilateral trading system. This occurred most markedly in the negotiations of the GATS which defines trade in services as including the provision of services through commercial presence. The TRIMs Agreement, in fact, focuses on one aspect of the policy interrelationship between trade and investment (performance requirements). Possible future work on investment and competition may lead to even deeper policy integration. A major question is the extent to which this new trend should be accommodated through the development of concepts designed to capture the relationships between investment and trade.

. . . and, in particular, that development issues must be and can be addressed

It was observed earlier that, for international agreements to be effective and stable, they need to take into account the interests of all parties, incorporate a balance of interests and allow for common advantage. This applies particularly to developing countries and, more generally, to agreements between countries at different levels of development. In particular, any agreement involving developed and developing countries must take into account the special importance of development policies and objectives. The development dimension can be addressed in international investment accords at all levels and in several ways.

Current international arrangements could either be allowed to evolve organically . . .

For analytical purposes, two basic approaches, two ideal types, regarding the further evolution of international arrangements for FDI can be distinguished.

One approach involves allowing current arrangements to evolve organically, while improving them actively by deepening and expanding them, as appropriate. The overarching rationale for this approach is that current arrangements are working well in providing an enabling framework that allows FDI to contribute to growth and development, and are supporting high and growing volumes of FDI. Moreover, such arrangements allow for groups of countries to enter into agreements having the degree of ''strength'' that is suitable to their circumstances.

. . . or a comprehensive multilateral investment framework could be sought, . . .

Another approach involves the construction, through negotiation, of a comprehensive multilateral framework for FDI. The overarching rationale for this approach is that the globalization of business, increased volumes and the growing importance of FDI, intertwined of FDI and trade and the emergence of an integrated international production system require a similarly global policy framework. In brief, in this view a global economy requires a global policy approach to create a stable, predictable and transparent enabling framework for FDI.

. . . although, in reality, these two policy approaches are not mutually exclusive

These two policy approaches have been presented for expositional purposes as stylized alternatives, to highlight differences, even at the risk of oversimplification. In reality, even the proponents of each option seldom make such a clear distinction. Those in favour of an approach that allows current arrangements to evolve organically include a diverse range of governments; their support for this approach, however, does not necessarily preclude support for an eventual multilateral framework. Conversely, governments seeking a comprehensive multilateral framework are actively strengthening bilateral, regional, interregional and specific multilateral agreements on FDI.

There appears, indeed, to be a consensus that greater international cooperation on FDI issues is desirable. This underlying consensus is reflected in both of the policy approaches. The differences among governments and others in their support for either of the above options—or some combination of the two—lie more in their opinions on how best to achieve greater cooperation. In this perspective, the two approaches can be seen as coexisting and, indeed, developing in a complementary manner.

The further development of international arrangements governing FDI needs to consider a number of issues, . . .

Since the further development of international FDI arrangements is being pursued at all levels, it is important to identify and analyse issues that need to be considered, especially with a view towards their implications for development. An examination of investment instruments provides a list of key issues that could reasonably be expected to be addressed:

- *Scope.* In any instrument on FDI, the forms and types of transactions and operations to which it applies need to be determined.

- *Investment measures* that affect entry and operations of foreign investors. Particularly relevant are issues relating to admission and establishment, ownership and control, operations, incentives and investment-related trade measures.

- Application, with respect to FDI, of certain *standards of treatment.* Particularly relevant are issues of national treatment, most-favoured-nation treatment, and fair and equitable treatment.

- Measures dealing with *broader concerns,* including the proper functioning of the market. Particularly relevant are issues relating to restrictive business practices, transfer pricing, transfer of technology, employment, the environment, and illicit payments.

- *Investment protection and the settlement of disputes.* Particularly relevant are issues relating to expropriations and property takings in general, abrogation (or unilateral amendment) of State contracts with investors, transfer of funds, and dispute settlement.

- *Procedural approaches.* There is also the issue of the legal character of a given instrument and the approach adopted regarding the mechanisms used to put it into effect.

Although extensive, this list of issues is by no means exhaustive. In addition, the relative importance of particular issues varies, of course, for different participants. While investment protection and liberalization, for instance, are especially important to TNCs, the implications for sustainable growth and development of all these issues are of particular significance for governments. Social policy questions, meanwhile, are special concerns of other groups, in particular trade unions and consumer groups.

. . . while always keeping at the forefront the development dimension

Because the activities of TNCs have such pervasive consequences for the development prospects of all countries, and in particular those of developing countries and economies in transition, any international arrangement involving the latter groups of countries has to be particularly sensitive to development needs. Broadly speaking, the development objective needs to be:

- *Safeguarded* by allowing countries in need of a transition period—through exclusion, exemptions and temporary measures—the time to adjust to more stringent standards of investment liberalization, it being recognized that many developing countries have already gone far on their own initiative;

- *Advanced* by agreeing that developing countries can take appropriate measures to increase the benefits that they can reap from FDI, without infringing on the essential interests of foreign investors;

- *Supported* by home country governments committing themselves to help developing countries attract FDI, in particular FDI that is most consonant with their development needs (e.g. because it embodies appropriate technology or is export-oriented). Governments of home countries can promote FDI flows to developing countries, e.g. through the provision of information and technical assistance; direct financial support and fiscal incentives; and investment insurance and tax-sparing provisions. While many home countries have already many measures in place in this respect, and some international instruments address this issue, not all do, and those that do can be strengthened.

Experience has shown that development objectives cannot only be accommodated, but actually be promoted by international agreements. The further development of international arrangements for FDI needs to keep this objective at the centre of its attention.

The choice of forum will, of necessity, shape how the framework will evolve, with the main choices being either regional and interregional forums . . .

Investment issues are currently the subject of discussion or negotiation in a number of regional and interregional forums. One important recent initiative was the launching, in May 1995, of negotiations aimed at the conclusion of a Multilateral Agreement on Investment among the members of OECD in time for the Organisation's ministerial meeting in 1997. The main aim of these negotiations is to eliminate discrimination between foreign and domestic investors. The agreement is intended to provide a broad framework for international investment, with high standards for the liberalization of investment regimes and the protection of investment, and with effective dispute-settlement procedures. While this agreement is being negotiated among OECD members only, it is meant to become a free-standing international treaty open also to non-OECD members. Evidently, one of the main challenges will be to obtain the adherence of non-OECD members.

Other regional and interregional forums have already addressed investment issues, or are in the process of doing so, including APEC, ASEAN, SADC, NAFTA and MERCOSUR, as well as the initiatives pursued in the context of the Free Trade Area for the Americas and the European Energy Charter Treaty.

. . . or a multilateral forum

Although multilateral rules on FDI could be established in an independent agreement, recent proposals aim at the negotiation of such rules in the framework of international organizations with global, or potentially global, membership. In particular, WTO has been mentioned as an appropriate forum for such negotiations. An important consideration underlying this suggestion is that the intertwining of investment and trade requires a more integrated approach to international rule-making. This has already manifested itself in the work of GATT and of WTO. Thus, WTO already deals with certain aspects of investment issues in the context of the agreements on trade in services, trade-related investment measures and trade-related aspects of intellectual property rights, and an agenda exists for the expansion and deepening of these rules. Negotiations on liberalization through the expansion of the GATS schedules of commitments are scheduled to take place before 1999, and the TRIMs Agreement provides for consideration of competition and investment issues by the same year.

Members of WTO are discussing a proposal for a decision to be taken at the first Ministerial Conference of WTO in Singapore in December 1996 to create a body to conduct a work programme on trade and investment. If such a decision were taken, it is likely to provide for exploratory work rather than the immediate launching of actual negotiation of a set of investment rules.

Finally, the question of a possible future multilateral framework on investment was addressed at the 1996 UNCTAD IX Conference at which it was agreed that UNCTAD should identify and analyse implications for development of issues relevant to a possible multilateral framework on investment, beginning with an examination and review of existing agreements, taking into account the interests of developing countries and bearing in mind the work undertaken by other organizations. The areas of policy analysis and consensus-building, with a particular focus on the development dimension, are, indeed, areas in which UNCTAD can make a contribution. ■