Preventing investment protectionism

Following a sharp rise in 2005, FDI inflows to the OECD area continued to rise, to reach some USD 400 billion in the first half of 2006, and the outlook in the coming years is positive overall. However, some risks cloud the horizon. In addition to the usual economic risks, a possible resurgence of international investment protectionism, or the perception that countries have become less open to foreign investment could dissuade potential investors. At a global level, this could have larger implications on capital accumulation and economic growth.

A number of OECD and non-member countries are taking or considering action to discourage foreign takeovers of enterprises judged sensitive. The motivations include national defence, energy security and the protection of technologies considered vital to national sovereignty.

The OECD Investment Committee is working to help policy makers to find ways to safeguard legitimate national security and essential public interests while at the same time keeping their investment regimes transparent and non-discriminatory and thus continuing to reap the demonstrated benefits of free international investment flows.

This issue of the Investment Newsletter puts the spotlight on this work, as well as on recent FDI developments and their measurement. It also reports on the results of the Investment Policy Review of the Russian Federation, with an analysis of capital control reform, Russia's approach to international investment in “strategic” sectors and recommendations on how to strengthen investment policy transparency.

Each year the Investment Committee publishes an annual report on how adhering governments' activities enhance the contribution of the OECD Guidelines for Multinational Enterprises - a leading international corporate responsibility instrument - to the improved functioning of the global economy. The final article in the Newsletter offers a summary of the latest report.

I would like to thank the many readers who responded to the first Investment Newsletter, whose purpose is to share with the wider investment policy community and other stakeholders the results of the OECD Investment Committee’s work. We received useful comments and suggestions on the content and style and this issue already takes on board some of your ideas.

Manfred Schekulin
Chair, OECD Investment Committee
Safeguarding an open international investment environment

A number of OECD and non-member countries are taking or considering action to discourage foreign takeovers of enterprises judged sensitive. The motivations go beyond just national defence, to include energy security or protection of technologies considered vital to national sovereignty. The challenge for governments is to find ways to safeguard essential interests while keeping their investment regimes transparent and non-discriminatory. The OECD Investment Committee is working with policy makers to find ways to meet this challenge so that countries continue to reap the demonstrated benefits of free international investment flows.

Freedom of investment is a core value of the OECD

The OECD is convinced of the long term benefits of an open international investment environment, including in respect of job creation, a more efficient resource allocation, and social and environmental progress. As the custodian of international investment instruments, the Organisation has overseen progress in liberalisation for more than 40 years.

Concerns about security and other essential national interests are on the rise

In recent years many countries have reassessed their priorities in response to a changing international security environment. Moreover, heightened concerns about access to raw materials, energy in particular, have countries looking to nationally based companies to secure supplies. And, the emergence of a number of new global economic players, whose corporate sectors do not fully subscribe to today's standards of business conduct, has raised concerns about safeguarding a "level" global playing field.

Many countries have taken steps to safeguard essential interests that, while not necessarily "protectionist" in nature, have nevertheless generated considerable public interest. Some European countries have shown uneasiness about international mergers in sectors as diverse as steel, banking, energy and toll-roads, and some have taken regulatory action. In the US, takeovers of a small oil company and of the management of some of its port facilities have been discouraged; Congress is considering ways of strengthening security screening of investment projects. China has recently tightened procedures for cross-border M&As. Russian and Indian authorities are reassessing their positions on foreign control of sensitive enterprises. And we have seen a resurgence of expropriation in some South American countries.

The cost of getting it wrong is substantial

While governments have a responsibility to safeguard national security, ceding to nationalist and protectionist impulses carries a cost. Other countries may interpret defensive measures as protectionist and begin to tighten their own investment regimes. Increasing barriers to cross-border ownership will impede the financing of new investment, hold back corporate efficiency gains and discourage innovation. The price of investment protectionism is a slower pace of sustainable development.

The way forward

In order to avoid a spiral of defensive measures that inhibit incoming investment, countries need to build mutual understanding and mutual trust. The OECD has begun consultations among member and non-member countries in order first to improve information about the various approaches being taken to protect security and other essential interests, and second to discuss the ways to avoid legitimate concerns giving rise to protectionist responses.

As a first step in this process, the Investment Committee organised in June 2006 a roundtable on Freedom of Investment, National Security and 'Strategic' Industries. The purpose of the roundtable was to solicit input from practitioners and policy makers regarding the directions such work could take.

The discussions were organised around three themes: recent changes in legislation and regulatory practices towards national security and other essential interests; the risk of protectionism and backtracking on previous commitments to liberalisation; and the role of international cooperation.

The next steps include:

- A comprehensive inventory of national investment policy practices in the area of national security and other essential interests;
- An analysis of selected issues, such as policies towards takeovers by foreign government-controlled entities and the challenge of identifying the ultimate beneficiary owner and the relevance of nationality in that context;
- A shared view of least-restrictive practices in the national interest; and
- The use of mechanisms of international cooperation, including joint monitoring to safeguard an open international investment environment.

For further reading on this topic:


A second roundtable is planned for December 2006, and a summary will be posted on the above website.
Trends and recent developments in FDI

Robust economic growth, strong corporate profitability, low borrowing costs and firm equity valuations are supporting higher levels of foreign direct investment in most OECD economies. Similarly, buoyant economic developments outside the OECD area are establishing international investment opportunities in new markets. The Chinese economy is now firmly established as one of the world’s foremost destinations for FDI, and India is quickly gaining momentum.

Inflows to the OECD area reached near record levels...

FDI into OECD countries reached USD 622 billion in 2005, up from USD 491 billion in 2004 and USD 465 billion in 2003 (see figure). These are the highest inflows since 2001. Quarterly figures for the first half of 2006 indicate continued growth in FDI flows to and from OECD countries (see table).

...with the UK attracting the largest share of inflows

The United Kingdom was the world’s largest recipient of inward FDI in 2005, attracting USD 165 billion from OECD countries. This is the largest inward direct investment ever recorded in the UK, tripling the level received in 2004, and 2006 suggests further growth.

Table 1. Foreign Direct Investment, billion US$

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>2006:S1</th>
<th>2005</th>
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</tr>
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<tbody>
<tr>
<td>Germany</td>
<td>32.6</td>
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<td>45.6</td>
<td>32.3</td>
</tr>
<tr>
<td>Belgium</td>
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<td>19.6</td>
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<td>.</td>
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<td>0.9</td>
<td>.</td>
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<td>40.4</td>
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<td>101.1</td>
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<td>1.5</td>
<td>0.4</td>
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<td>1.3</td>
<td>0.7</td>
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<tr>
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<tr>
<td>New Zealand</td>
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<td>1.5</td>
<td>-0.3</td>
<td>-0.2</td>
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<tr>
<td>Poland</td>
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<td>5.8</td>
<td>1.5</td>
<td>0.3</td>
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<tr>
<td>Portugal</td>
<td>3.1</td>
<td>2.4</td>
<td>1.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1.9</td>
<td>2.1</td>
<td>0.1</td>
<td>0.2</td>
</tr>
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<td>Sweden</td>
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<tr>
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<td>1.0</td>
<td>0.0</td>
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<tr>
<td>United States</td>
<td>109.8</td>
<td>96.4</td>
<td>91.1</td>
<td>119.0</td>
</tr>
</tbody>
</table>

Total            | 261.7 | 392.9   | 716.1 | 439.0   |

Sources: OECD Balance of Payments Statistics and OECD International Investment Statistics.
1. Totals are calculated disregarding the missing figures for Austria, Norway and Switzerland.

Most inflows reflected cross-border mergers and acquisition activity

Over the past one and a half years, large cross-border merger and acquisition activity has been generally evenly distributed across sectors. The two main target countries for large M&A were the United States and the United Kingdom, with the continental European economies, south Europe and the rest of the world relatively less active in 2005 and early 2006.

Outflows from the OECD area exceeded the inflows

France was the world’s most active outward investor in 2005, with aggregate flows totalling USD 116 billion, due largely to a few very large foreign corporate takeovers by companies domiciled in France. In the first half of 2006, outflows from France have eased while rising sharply in Spain.

China and India are becoming magnets for FDI...

Outside the OECD area, China continues to hit new records. In 2005 its total FDI inflows reached USD 72 billion – their highest level ever and exceeded only by the United Kingdom and United States.

Likewise, inward direct investment to India continues to grow, reaching an all time high of USD 6.5 billion according to national sources in 2005. Moreover, this is likely to be an underestimate, as recent sectoral liberalisation means an increasing proportion of inward FDI now arrives unscreened and not always captured by the data collection systems.

...as well as sources of FDI

China, India and other large emerging economies are also assuming an increasingly active role as outward investors. Poor data quality often makes it hard to depict the form and destination of these outflows. Estimates of USD 7 billion in outflows in 2005 by China’s Ministry of Commerce, for instance, are almost certainly an underestimate. A high proportion of these outflows are going to the developing world, particularly Africa, raising concern in some countries over competition for scarce energy resources and over possible undermining of internationally-recognised standards of corporate conduct.

For further reading on this topic:
OECD work on FDI statistics:
www.oecd.org/daf/investment/statistics
Progress towards better FDI statistics

Foreign direct investment is one of the major drivers of globalisation. It provides a means for creating direct, stable and long-lasting links between economies, and also serves as vehicle for local enterprise development. New technologies are expanding the horizons of foreign investors and creating new patterns of industrial organisation. Better understanding of these processes requires reliable and comparable FDI statistics for meaningful policy analysis. Work is in progress towards updating and revising the concepts that underpin FDI statistical collection systems. This article provides a brief overview.

What do FDI statistics measure?
Foreign direct investment is defined as international investment by a resident entity in one economy - the direct investor - with the objective of obtaining a lasting interest in an enterprise resident in another economy - the direct investment enterprise. Ownership of 10% or more of the equity is a basic criterion for determining the existence of a direct investment relationship for statistical purposes.

FDI statistical challenges arising from globalisation
The application of this definition for the collection of reliable and comparable statistics poses a number of challenges, in particular as the process of globalisation advances. For example, because multinational enterprises frequently use “pass through” funds, or special purpose entities domiciled in other countries to finance acquisitions, analysis of the ultimate home or host country investing enterprise is blurred. There is a need to separate purely pass-through investment, and ideally trace such flows back to their origin and forward to their destination.

The revision of the FDI Benchmark Definition...
In response to issues such as pass through investment and others, the OECD Benchmark Definition of Foreign Direct Investment is being revised. New methodologies are under development to identify “genuine FDI”, i.e. identifying the ultimate host or investing country or industry and eliminating “pass-through transactions” or “capital in transit” through non-operating intermediaries.

... is based on established principles and practices...
The Benchmark Definition first published in 1983 sets the world standard for direct investment statistics. It recommends a set of principles and practices for the collection of FDI statistics designed to avoid inconsistencies between countries, to reduce global discrepancies, to achieve consistent statistical series over time and to allow a meaningful exchange of data between partner countries. It is also fully compatible with the underlying concepts and definitions of the IMF Balance of Payments (BOP) Manual and it follows the general economic concepts set out by the System of National Accounts. The BOP Manual is being updated in parallel, providing the opportunity to maintain full compatibility.

... and will improve understanding of globalisation through FDI
While preserving these principles, the revision of the Benchmark Definition aims to meet a number of objectives with concrete benefits (see box).

While the main focus of the Benchmark Definition is FDI statistics encompassing direct investment positions and related direct investment financial and income flows by partner country and by economic activity, efforts are being made to better link FDI statistics with data on the activities of the foreign affiliates of multinational enterprises. This will help policymakers to understand better the evolving patterns of industrial globalisation and to design investment policies that ensure the benefits are reaped with minimum adjustment costs.

The new Benchmark Definition of Foreign Direct Investment will be published in early 2008.

For further reading on this topic:
OECD work on FDI statistics: www.oecd.org/daf/investment/statistics
New investment policy review of Russia

The 2006 Investment Policy Review (IPR) of the Russian Federation examined developments in Russia’s investment regulatory environment since the last OECD Review in 2004. It also includes an analysis of capital control reform and a survey of Russia’s approach to international investment agreements. In assessing these developments and offering options for further improvements, policy transparency has been the focus of the Review. Enhancing the policy framework for investment will allow Russia to attract more and better international investment, stimulating its sustainable growth, economic diversification and modernisation.

More international investment is needed to support Russia’s economic development and diversification

Since 2003, Russia has attracted increased amounts of foreign direct investment, which reached record levels in 2004 and 2005. However, the share of FDI in domestic capital formation remains low by international comparison. In 2005 the manufacturing sector attracted the largest FDI share and the energy sector absorbed one third of inflows, but Russia’s service sectors have not yet benefited from significant FDI. Russia’s international investment statistics provided by the Central Bank of Russia have been improved in line with OECD standards, but consistency problems between different Russian data sources persist.

Despite progress, the level of restrictions on foreign investment remains above the OECD average.

Russia’s formal barriers on FDI are high in sectors such as insurance, energy and transport, whereas some other sectors such as distribution and business services have been opened up. In addition to equity restrictions, foreign investors face impediments in licensing procedures and other business-related regulations concerning, for example, foreign personnel, often aggravated by the lack of predictability.

The OECD Review shows that insufficient policy transparency remains a serious obstacle to investment

Based on an OECD business survey carried out in 2005, foreign investors acknowledged improvements in information access and administrative simplification in a number of areas, such as foreign exchange regulations, but expressed concerns on non-transparent implementation in other fields, often under regions’ competence, including land and property registration and work permits. The business community also finds prior consultation on regulatory changes insufficient.

New laws on Special Economic Zones and Concessions can have a positive impact on investment

Costly investment promotion efforts and targeted investment incentives have not been effective in helping regions attract more foreign investment. The new laws do not discriminate against foreign investors and can allow regions to exploit their potential comparative advantages better if implemented in a non-discriminatory, transparent and least market-distorting manner.

The forthcoming law on “strategic sectors” will be a test of the government’s commitment to transparency

Consistent with best practice under the OECD instruments, the Investment Policy Review recommends that the future law define narrowly the sectors concerned, limit the scope of restrictions to foreign control over domestic companies based on a strict interpretation of essential security interests, and clarify the modalities of government review and permission procedures.

The Review supports the decision to abolish remaining capital controls in 2006...

The experience of financial market participants is that the current system of capital controls has been too complex, insufficiently transparent, often ineffective and costly for both foreign and domestic investors. Consistent with the OECD instruments, the removal of capital controls which took place six months ahead of the deadline set by the 2004 Foreign Exchange Law needs to be accompanied by supporting measures, including statistical reporting, appropriate tax control, anti-money laundering and non-discriminatory prudential safeguards.

... and invites continued efforts by the Russian authorities to enhance investment policy transparency.

The IPR welcomes the planned reduction of activities subject to mandatory licensing and the establishment of a Register of regional and municipal legislation. It encourages a speedy adoption of the new law on access to information submitted by the government in 2005. The Review also recommends more effective consultations with interested parties, publishing and reviewing administrative decisions, and using electronic dissemination of investment regulations more extensively. It suggests the application and disclosure of regulatory impact assessments for special investment incentives regimes. The IPR also encourages the inclusion of strong transparency discipline into Russia’s future investment agreements.

For further reading on this topic:


www.oecd.org/daf/investment/development
OECD Guidelines for Multinational Enterprises: six years on

Strengthened in 2000, the OECD Guidelines for Multinational Enterprises provide a global framework for responsible business conduct and a unique, government-backed implementation procedure. Every year, the National Contact Points (NCPs)* of the 39 adhering governments meet to take stock of their experiences and examine how they can promote the Guidelines. The last meeting of the NCPs took place on 20-21 June 2006, and focussed on promotion and mediation under the Guidelines. The results of this work are disseminated through an annual report. The next edition will be published in December and this article describes the highlights.

The Guidelines have established a firm track record

The OECD Guidelines for Multinational Enterprises are a comprehensive code of conduct with recommendations on a broad range of issues (see figure). These cover such areas as encouraging good conduct in supply chains, respecting all core labour standards, environmental protection and combating bribery. While observance of the Guidelines is voluntary for businesses, adhering governments are committed to promoting them and to encouraging their observance by companies operating in or from their territories.

The 2006 Annual Report on the OECD Guidelines for Multinational Enterprises describes what governments have done to live up to this commitment over the period June 2005 to June 2006. The report shows that the Guidelines have established an impressive track record. It describes, for instance, how the “specific instances” procedure - a mediation facility maintained by the NCPs - has contributed to reducing tensions and building trust between international business and host societies. Ninety six such “specific instances” have been mediated by NCPs since the 2000 review, of which 24 in the latest reporting period. Another highlight of the implementation cycle was the completion of guidance for companies operating in weak governance zones.

A pro-active approach to promoting the Guidelines

Corporate managers use the Guidelines. In the area of human rights, for instance, 41% of the respondents to a 2006 survey of Fortune Global 500 firms indicated that their companies use the Guidelines as a reference.

Government agencies increasingly use the Guidelines as a tool for communicating expectations to business. For example, 24 countries made use of the Guidelines in the context of export credits or investment guarantees or in trade and investment promotion campaigns. And a majority of countries are using their embassy networks to promote and implement the Guidelines.

More is being done to reach out to non-Members

Sustained efforts to foster the Guidelines is generating a growing community of countries, organizations and individuals that work together to promote their observance. China, Russia and other emerging markets now look to the OECD Guidelines as a key benchmark. This is reflected in a number of new applications to adhere to the OECD Declaration recently received from countries in the Middle East and East Asia, and a new OECD project to promote responsible business conduct in China.

Next steps

Looking ahead, the next steps will include efforts to improve co-operation with other initiatives and among stakeholders. An interesting development in this regard is the recent agreement between the German NCP and the local UN Global Compact network under which, the NCP agrees, when appropriate, to consider alleged problems of observance of the UN Global Compact Principles as a “specific instance” under the OECD Guidelines. Such initiatives as the United Nation’s Global Compact, the Extractive Industries Transparency Initiative, the Global Reporting Initiative and the Guidelines complement and reinforce each other in many ways and there is scope for more mutually beneficial co-operation.

*A note: NCPs are government offices (sometimes involving participation by business, trade union and NGO representatives) located in each of the 39 countries adhering to the OECD MNE Guidelines. They are charged with promoting the OECD Guidelines among MNEs operating in or from the country in question.

For further reading on this topic:


**Selected Investment Committee publications**

Investment for Development provides a record of the OECD Investment Committee’s co-operation programmes with non-member economies and their results. These extensive co-operation activities are organised around three dimensions: global events, regional initiatives and dialogue with individual countries. This report documents how these initiatives help to strengthen implementation capacities and best practices among non-members, drawing on the broad applicability of the principles and expertise the OECD has developed in the area of international investment, including the positive contribution of responsible international business. The 2006 edition will be launched at the OECD Global Forum on International Investment in Istanbul on 6-7 November.

**OECD Risk Awareness Tool for Multinational Enterprises in Weak Governance Zones**
Weak governance zones are defined as countries where governments are unable or unwilling to assume their responsibilities. About 15% of the world’s people live in such countries. Multinational enterprises recognise that they represent some of the most difficult investment environments. This Risk Awareness Tool helps them to identify some of the special risks that arise in these environments, those that are linked to government failures. It covers such topics as obeying the law and observing international instruments; political activities; knowing clients and business partners; and speaking about wrongdoing. In the next phase, business and stakeholders will work with OECD to identify sources of practical experience in meeting the challenges the Tool addresses. The text of the Risk Awareness Tool is available on the OECD website at [www.oecd.org/investment](http://www.oecd.org/investment).

**Policy Framework for Investment: Review of Good Practices**
The objective of the Policy Framework for Investment is to mobilise private investment that supports steady economic growth and sustainable development. It thus aims to contribute to the prosperity of countries and their citizens as well as to support the fight against poverty. This Review of Good Practices in OECD and non-OECD economies is published as a companion volume to the Framework and provides analytical background material on each of the ten chapters of the Framework. The text of the Policy Framework for Investment is available on the OECD website at [www.oecd.org/investment](http://www.oecd.org/investment).

**International Investment Perspectives**
International Investment Perspectives offers an update of recent trends and prospects in international direct investment and provides analysis of investment policy questions of topical interest. The special focus of the 2006 edition is on legal and policy issues arising from international investment agreements including: novel features of recent bilateral investment treaties; options for improving the system of investor-state dispute settlement; and the consolidation of claims as an avenue for improving investment arbitration and a special review of India’s investment agreements. Also included are articles taking stock of how new technologies are a force advancing the closer integration of national economies, reviewing the challenges and opportunities for policy makers that arise from international investor participation in infrastructure, summarising recent evidence of source country benefits of outward direct investment and explaining the role of the OECD peer review process in building investment policy capacity.

Several options are available for obtaining publications:
- Additional information and links can be found via the investment portal on the OECD website: [www.oecd.org/investment](http://www.oecd.org/investment)
- Subscribers and readers at subscribing institutions can access the online edition via the online library: [www.sourceoecd.org](http://www.sourceoecd.org)
- Non-subscribers can purchase the PDF e-book and/or paper copy via our Online Bookshop: [www.oecd.org/bookshop](http://www.oecd.org/bookshop)
- Government officials can find the PDF e-book via the publication locator on OLISnet: [www.oecd.org/OLISnet](http://www.oecd.org/OLISnet)
- Accredited journalists can obtain password access via the Newsroom: [www.oecd.org](http://www.oecd.org)
Forthcoming events

6-7 November 2006
OECD Global Forum on International Investment
“Enhancing the investment climate: the case of infrastructure”

This year’s annual OECD Global Forum on International Investment (GFII) will take place in Istanbul on 6-7 November 2006.

The main individual topic will be international investor participation in infrastructure. Governments around the world are increasingly inviting international investment into their infrastructure sectors, to leverage public finance and in order to reap efficiency gains. Not all projects have been successful. The GFII will discuss the experiences so far and try to establish success criteria, including regarding the domestic investment climate, modes of public-private co-operation and responsible business conduct.

Investment policy using the PFI will be the theme of the forum. Participating countries will be invited to present their investment climate and policies, applying the PFI by self-assessment and encouraging peer discussions and comparisons with the experiences of other countries.

Preceding the Forum, participants will have an opportunity to take part in an OECD/Turkey Investment Roundtable. A separate one-day Workshop on Public-Private Partnerships for Infrastructure Financing, organised within the framework of the MENA-OECD Initiative on Governance and Investment for Development, will take place on 8 November 2006.

Further information on the GFII can be found at: www.oecd.org/investment.

Contact: Sebastian Gerlach, Organiser, Global Forum on International Investment, Investment Division, [+33(0)145241491]

12-13 December 2006
NEPAD-OECD Africa Investment Initiative

The NEPAD-OECD Africa Investment Initiative aims to mobilise private investment and raise the profile and image of Africa as a place to invest, by identifying and implementing concrete policy reforms that strengthen the investment environment.

A Roundtable will take place in Brazzaville, Congo on 12-13 December 2006. The Roundtable will focus on how to make the most of peer learning methods within the context of the African Peer Review Mechanism (APRM) process. Specifically, it will explore how the Policy Framework for Investment (PFI) – a new tool to assist government to mobilise private investment – could be used to assist African countries prepare a programme of action within the APRM process.

Further information on the Initiative can be found at: www.oecd.org/daf/investment/development.

Contact: Jonathan Coppel, Lead Manager, NEPAD-OECD Africa Investment Initiative, Investment Division [+33 (0)145241447]