EXECUTIVE SUMMARY

Foreign direct investment (FDI) has been one of the defining features of the world economy over the past two decades. It has grown at an unprecedented pace for more than a decade, with only a slight interruption during the recession of the early 1990s. More firms in more industries from more countries are expanding abroad through direct investment than ever before, and virtually all economies now compete to attract multinational enterprises (MNEs). As a result, global flows reached an historic high of US$ 340 billion in 1996.

This trend has been driven by the complex interaction of technological change, evolving corporate strategies towards a more global focus and major policy reform in individual countries. The past decade has witnessed an unparalleled opening and modernisation of economies in all regions, encompassing deregulation, demonopolisation, privatisation and private participation in the provision of infrastructure, and the reduction and simplification of tariffs. An integral part of this process has been the liberalisation of foreign investment regimes. Indeed, the wish to attract FDI has been one of the driving forces behind the whole reform process. Although the pace and scale of reform has varied depending on the particular circumstances in each country, the direction of change has not.

Openness to foreign investment nevertheless remains partial in many countries. While there has been a growing acknowledgement of the role that direct investment can play in stimulating economic growth and development, there remains a tremendous diversity in approaches of countries in their policies towards FDI, as well as a lingering scepticism in certain spheres as to the inevitability or universality of the benefits from FDI. At a Global Investment Forum hosted by UNCTAD, it was reported that “[t]here was a strong feeling among ministers from some developing countries that more research and analysis was needed about the critical issues at stake in a multilateral framework on investment...and many speakers stressed the complexity of the issues related to the effects of economic policy liberalisation on the quantity,
quality and distribution of FDI, and its impact on development. As a result, many countries screen incoming investment and retain extensive controls on foreign participation in particular sectors. Performance requirements on investment are sometimes still considered necessary or desirable to ensure that the activities of foreign multinationals are consonant with host country development strategies.

This study examines the link between policy reform and FDI, based on the experience of six dynamic non-Member economies: Argentina, Brazil, Chile, Indonesia, Malaysia and the Philippines. The analysis is based on case studies of these countries which assess the extent of reform in each country and the response of foreign investors. The case studies are summarised in Annex 2. The six countries have all adopted different policies towards FDI, but to a great extent they are all converging on a more open approach. This greater openness, and the overall economic reforms of which FDI liberalisation is but one part, have transformed these economies in ways which will provide a more fertile environment in which to reap the potential benefits from FDI.

Direct investment by MNEs has the potential rapidly to restructure industries at a regional or global level and to transform host economies into prodigious exporters of manufactured goods or services to the world market. In so doing, FDI can serve to integrate national markets into the world economy far more effectively than could have been achieved by traditional trade flows alone. As with private sector investment more generally, the benefits from FDI are enhanced in an environment characterised by an open trade and investment regime, an active competition policy, macroeconomic stability and privatisation and deregulation. In this environment, FDI can play a key role in improving the capacity of the host country to respond to the opportunities offered by global economic integration, a goal increasingly recognised as one of the key aims of any development strategy.

Integration with the global economy does not just come through direct exports of foreign-owned firms. It also derives from the presence of foreign MNEs in sectors providing goods and services to exporters. One such area is in the provision of infrastructure. The infrastructure needs of many countries often go beyond the ability of host governments to finance. Foreign investors have participated actively in the privatisation of utilities in South America and Asia, particularly through build-operate-transfer schemes in the case of the latter. Power shortages which plagued growth in countries like the Philippines have virtually disappeared in the process. Foreign owners of domestic utilities have also significantly improved the quality of services provided, often at lower cost.
In other areas which impinge on the attractiveness of economies for investors, reforms have been slower in a number of countries and foreign investors have been much less actively courted. One such area is financial services. The weakness of the financial sector throughout emerging Asia has been highlighted by the recent turmoil. It remains to be seen whether this will lead to a greater openness towards foreign financial institutions, but a strong case can be made that foreign participation in the local financial sector can help to reduce the risks of future crises.

The Asian financial crisis has not altered these fundamental arguments for greater liberalisation. Indeed, it has made the case for such openness even more compelling. Some of the structural weaknesses which have come to light over the past year can be related to policies which restricted FDI or private sector investment more generally, or which sought to channel such investment into particular sectors. Policies towards FDI have often been part of broader industrial strategies.

A central theme which emerges from the country studies is that the effectiveness of a given policy is not constant over time. Some host countries were able in the past to attract inward investment by offering a large and protected market. Both Argentina and Brazil received substantial inflows of direct investment in the early years of import substitution, only to see their share of developing country inflows fall precipitously in the 1980s. Market saturation and the lack of dynamism in the local economy as a result of protection eventually places a limit on the future growth of inflows as MNEs gravitate towards more dynamic markets. Trade and investment liberalisation in both Argentina and Brazil, as part of more general economic reforms, have reversed this trend in the 1990s.

The same decline in effectiveness can be seen in terms of policies designed to maximise the potential benefits from inward investment. Many host countries made use of performance requirements in the past, such as exporting requirements or technology transfer agreements. As foreign affiliates of MNEs become more oriented towards global or regional markets and hence less dependent on the domestic market and as the number of countries eager to attract FDI grows, the tolerance of foreign investors for barriers and restrictions on their operations is likely to be much less than in the past. In this sense, the cost of investment restrictions has risen.

Many of the remaining barriers to inward investment were erected at a time when foreign firms were investing in economies distorted by trade barriers, a lack of effective competition in product markets, under-developed
financial markets and by many other policies associated with import substitution. In this environment, host countries sometimes justified restrictions on inward investment on the basis of the theory of second best which argues that liberalisation in one area in the presence of distortions elsewhere may make the economy worse off. In the more competitive environment in many host countries today as a result of roughly a decade of economic reforms, many restrictions are at best ineffective and at worst counter-productive.

The policy environment matters not just for its effect on FDI inflows but also because of the way it influences the potential benefits from those inflows. In the import-substituting environment found in many host countries in the past, the gains from FDI tended to be disappointing, particularly in the area of technology transfer. After a decade of economic reforms, host countries are better placed to realise the full benefits from inward investment than they were in the past. These benefits could be further enhanced as the process of liberalisation continues.
INTRODUCTION

Foreign direct investment (FDI) has been one of the defining features of the world economy over the past two decades. It has grown at an unprecedented pace for more than a decade, with only a slight interruption during the recession of the early 1990s. More firms in more industries from more countries are expanding abroad through direct investment than ever before, and virtually all economies now compete to attract multinational enterprises (MNEs). As a result, global flows reached an historic high of US$ 340 billion in 1996.

This trend has been driven by the complex interaction of technological change, evolving corporate strategies towards a more global focus and major policy reform in individual countries. The past decade has witnessed an unparalleled opening and modernisation of economies in all regions, encompassing deregulation, demonopolisation, privatisation and private participation in the provision of infrastructure, and the reduction and simplification of tariffs. An integral part of this process has been the liberalisation of foreign investment regimes. Indeed, the wish to attract FDI has been one of the driving forces behind the whole reform process. Although the pace and scale of reform have varied depending on the particular circumstances in each country, the direction of change has not.

Openness to foreign investment nevertheless remains partial in many countries. While there has been a growing acknowledgement of the role that direct investment can play in stimulating economic growth and development, there remains a tremendous diversity in approaches of countries in their policies towards FDI, as well as a lingering scepticism in certain spheres as to the inevitability or universality of the benefits from FDI. At a Global Investment Forum hosted by UNCTAD, it was reported that “[t]here was a strong feeling among ministers from some developing countries that more research and analysis was needed about the critical issues at stake in a multilateral framework on investment...and many speakers stressed the complexity of the issues related to the effects of economic policy liberalisation on the quantity,
quality and distribution of FDI, and its impact on development. As a result, many countries screen incoming investment and retain extensive controls on foreign participation in particular sectors. Performance requirements on investment are sometimes still considered necessary or desirable to ensure that the activities of foreign multinationals are consonant with host country development strategies.

This study assesses the link between policy reform and FDI, beginning with a detailed assessment of how much reform has actually been undertaken. Disappointment with levels of FDI and with the expected benefits in terms of technology transfer, etc. can be related to the policy environment in which firms have invested. This environment is not simply a function of FDI legislation but also relates to the level of competition in each market and the scope for private sector activity in general. Thus, it is important to look also at trade and competition policy and at the role of regulation and the State in the economy.

Because of the diversity of policies affecting FDI, the variety of motives behind an investment decision and, most importantly, the interaction between the two, this study adopts a case study approach. It examines the experience of several dynamic non-Member economies with respect to foreign direct investment. How important has inward investment been in quantitative terms in each country? How prominently has it figured in the development strategies of these countries? Has there been a liberalisation of FDI regimes over time? If so, what scope is there for further liberalisation in each country? What role have foreign-owned firms played in transforming the domestic economy as a result of overall economic reform, including privatisation and trade reform? Has such reform, including FDI liberalisation, increased the quantity or improved the quality of the foreign investments received? To what extent have these countries become outward investors in their own right?

The case studies include Argentina, Brazil, Chile, Indonesia, Malaysia and the Philippines. They are not taken to be representative of all host countries, but rather are among the most active recipients of FDI and offer advantages in terms of national or regional market size which many other developing countries cannot. To varying degrees, all these countries have embarked on a process of economic reform in which foreign investors are expected to play a role, but the pace of change and the initial starting points differ greatly.

At first glance, South America and Southeast Asia appear to have little in common. Historically, culturally, geographically and, to some extent
politically, they are very different. Argentina, Brazil and Chile are also, on average, four times richer than Indonesia, Malaysia and the Philippines. In terms of their policies towards foreign investors, there are as many differences within regions as there are between them. Some countries have tended to welcome FDI for its contribution to exports, while in others, inward investment was accepted for its role in import substitution, but foreign firms were nevertheless constrained to operate within a generally restrictive atmosphere. In most cases, the six countries have operated a mixture of the two approaches.

On closer inspection, the experience of each country with respect to FDI and the measures and practices applied towards that investment share many similarities across countries, not least in the common evolution towards a more liberal environment. What has differed has been the ability of each country to sustain inward-looking policies over time. Those countries with a large domestic market or significant oil revenues have tended to remain closed longer, although few countries have followed a consistent approach to FDI policy over a long period. In all cases, there have been substantial changes – sometimes dramatic reversals – in policies. As a result, changes over time in each country have often been greater than differences across countries at any point in time.

The past decade has witnessed an unparalleled opening and modernisation of economies in all regions. This includes deregulation, demonopolisation, privatisation and private participation in the provision of infrastructure, and the reduction and simplification of tariffs. An integral part of this process has been the liberalisation of foreign investment regimes. Indeed, the wish to attract FDI has been one of the driving forces behind the whole reform process. Because the pace and scale of reform in each of the six countries of this study have been very different, a comparison of approaches allows an assessment of how multinational enterprises have responded to these dramatic changes in each country and how FDI liberalisation, as part of a broader package of reform, is likely to lead to an improvement in the quality of investment received from abroad.

General characteristics of the countries in this study

Table 1 compares the six countries in this study by various criteria. The Latin countries tend to be, on average, four times richer and offer a market almost three times larger. While it is common for larger countries to be less export oriented, the Latin countries are nevertheless significantly less outward looking except for Chile which exports substantial amounts of copper.
Malaysia is a prodigious exporter given the small size of its economy, and foreign firms have played a major role in this development. The other two Asian countries, although less impressive in this respect than Malaysia, nevertheless are more outward oriented in their production than the countries of South America. While the degree to which a country exports represents a complex mixture of factors such as natural resources, industrial mix, geography, it is also a function of Government policies. In South America, decades of import substitution have made exports from these countries less competitive in world markets. The final item on the share of the State in economic activity will be discussed later. These countries have privatised substantially since the period shown in Table 1.

The six countries in this study are among the most important recipients of inward investment outside of the OECD area (Table 2). With the exception of the Philippines, all countries have been among the top ten non-OECD recipients of FDI in the 1990s. Four of the countries are also among the top 20 global recipients of FDI. Although the three Asian countries in the study are prominent hosts for FDI in the non-OECD area, they have still received only 42 per cent as much investment in the 1990s as China. Indeed, the rapid rise of China in this decade has been perceived as a threat by some of these countries in terms of their continued ability to receive substantial amounts of inward investment.
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<tr>
<th>Market size</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Chile</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
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<tr>
<td>GNP per capita (US$) 1995</td>
<td>8 030</td>
<td>3 640</td>
<td>4 160</td>
<td>980</td>
<td>3 890</td>
<td>1 050</td>
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<td>Population 1995</td>
<td>35</td>
<td>158</td>
<td>14</td>
<td>194</td>
<td>21</td>
<td>70</td>
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<td>GNP (US$ million) 1995</td>
<td>281 050</td>
<td>575 120</td>
<td>58 240</td>
<td>190 120</td>
<td>81 690</td>
<td>73 500</td>
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<th>Trade</th>
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<td>Share of world exports 1994</td>
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<td>Export growth 1988-9 to 1992-3</td>
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<td>Manufactured share of exports</td>
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<td>High-technology share of mfg. exports</td>
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<td>Exports as percentage of GDP, 1995</td>
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| Economic activity of SOEs as percentage of GDP, 1986-91 | 4.7% | 8.6% | 12.9% | 14.1% | 17.0% | 2.4% |