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FOREIGN DIRECT INVESTMENT IN THE CARIBBEAN BASIN BACKGROUND AND ISSUES

This paper is for discussion at the OECD Conference on Foreign Direct Investment in the Caribbean Basin which will take place in Santo Domingo, Dominican Republic, on 11-12 April 2000.

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Foreign Direct Investment in the Caribbean Basin

Background and Issues*

Introduction

1. Globalisation is already widely acknowledged as an irreversible trend. Liberalisation and deregulation are taking place in almost every corner of the world with the aim of allocating resources more efficiently in an environment which is favourable for free flow of resources seeking higher efficiencies. Technological progress further accelerates the rate of globalisation by making better means of production and transaction available. Multinational enterprises (MNEs) play a central role in this phenomenon as agents for mobilising tangible and intangible assets. In many cases, the mobilisation of these assets takes the form of foreign direct investment (FDI).

2. Today's dynamic environment imposes a very challenging task for policy makers in charge of policy formulation on investment and corporate affairs. These policy makers need to quickly evaluate the current situation, new opportunities and threats, and re-direct the course of the future. It requires gathering of accurate and the most up-to-date information and constant reassessment of policies based on that information. The theme is very appropriate for Latin America and the Caribbean at present. The region has undergone some dramatic structural changes in the last decade or so. It is worthwhile to re-evaluate the efforts undertaken by the countries of the region and to learn from both their successful and not-so-successful initiatives.

Foreign Direct Investment in Latin America and the Caribbean

3. Latin America and the Caribbean have experienced sweeping economic reforms and market liberalisation since the mid-1980s. This has involved a substantial liberalisation of the investment regime in most of these countries. Some common elements in the new investment regimes are the granting of national treatment and the elimination of most restrictions on capital and profit remittances. The new regulatory regimes allow countries to accept international arbitration as a means of solving disputes that might arise between the host country and foreign investors. This is a significant contribution in reducing the obstacles to investment negotiations between the countries in the region on one hand and capital exporting countries on the other.

4. The 1990s has also witnessed an unprecedented growth in the number of agreements covering rules on FDI in the region, either bilateral or multilateral. The North American Free Trade Agreement, the Andean Pact and Mercosur treaties all include investment provisions. Numerous free trade agreements with investment provisions have also been signed between the countries of the region. These are significant achievements in improving the regulatory framework for investment.

5. Countries in the region have proved that their commitment to liberalisation and deregulation is irreversible throughout the 1990s. A series of privatisation programmes were also initiated in the region, which demonstrate the commitment to restructure the economies. This series of movements towards a positive environment for investment has resulted in a healthy growth of FDI for Latin America and the Caribbean.

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6. Global FDI flows marked a record level of US\$650 billion in 1998, demonstrating the continued and accelerating globalisation process. The phenomenal increase of world FDI flows in 1998 was largely led by a series of mega-cross-border mergers and acquisitions (M&As). As a result, there was a higher concentration of flows within the developed countries.

7. Latin America and the Caribbean was the only region in the developing world to increase inward FDI. It put the region almost at the same level as Asia in terms of shares of total FDI received. This was largely due to the sluggish FDI flows into Asia in the aftermath of the financial crisis. FDI in Latin America amounted to US\$75 billion in 1998. Latin America was not isolated from the wave of M&As: the number of deals concluded in the region has increased considerably in recent years (KPMG 1999). Approximately US\$11 billion went to the Caribbean Basin countries (ECLAC 2000). Considering the size of their economies, this is not an insignificant amount. For the majority of countries in the region, which are small island economies, the amount of FDI may be significant for the size of its economy or its gross capital formation. In fact, some of these island economies have a larger FDI per share of GDP than some large developing economies that appear on the list of largest FDI recipients in real term (UNCTAD 1999).

8. Countries in the region vary in size, factor endowments and in their investment support institutions. This explains the diversity of foreign interests in the region. In recent years, there is a shift from natural resource based investment to services sector, while the share of the manufacturing sector has remained unchanged (ECLAC 2000). The dynamism of FDI in manufacturing sector is suggested in the growth of sales and export by foreign manufacturing companies based in the region. Both export and sales for domestic market grew significantly in recent years. It suggests that the region managed to attract a wide range of foreign investors to serve varying needs of the host economies.

9. FDI outflows from the region in recent years have recorded a substantially higher level than the beginning of the 1990s. This may be partially explained by the political and institutional initiatives of the regional integration. Additionally, the series of liberalisation and structural reforms have significantly increased competitive pressures on domestic firms, and have induced processes of restructuring at firm level in the economies of the region.

Questions for discussion

1. ***Is the current level of FDI in the region sustainable?***
2. ***What are the prospects for the smaller countries in the region?***
3. ***In what areas do participant countries maintain restrictions on investment by foreigners? What is the rationale?***
4. ***What are the attractions of the region for foreign investors?***
5. ***Can the region build on its advantages to attract specific growth industries?***
6. ***Can countries in the region maintain a competitive advantage over competitors for foreign investment?***
7. ***What are the impacts of regional trade agreements on FDI?***

Creation of an Enabling Environment

10. Institutional arrangements may further enhance the investment climate to capture the momentum of FDI growth in the region. Investment promotion agencies have an important role to play in helping to develop a suitable policy framework for investment and private sector development. Furthermore, these agencies are important in providing reliable information on investment opportunities, as well as other services. This task should not be undermined. As foreign investors have a variety of investment locations to choose from, making investors aware of the opportunities and improving national image can often determine the attractiveness of the country as a host for a particular investment. The countries in the region have established new agencies or have re-constituted existing agencies in recent years.

11. Provision of accurate information is certainly important. For this, the role of agencies in compiling information may need to be re-examined as well. Statistics are fundamental tools for analysing the current situations, and FDI and other statistical sources are undoubtedly crucial for investment decision making. However, it is widely acknowledged that these statistics have various shortcomings in the quality of information and comparability across the countries. The methodology for compiling some statistics should be revisited in the light of new technological developments in this field, while the implications for analysis, based on such data, should be re-evaluated.

12. While investment promotion strategy may influence investors' preference for a certain country, there are many other factors which play a role. Foreign investors often have different, more complex, motives than the host country. In order to create longer-term competitive advantages, host countries must often introduce institutional reforms. Among the areas of institutional reforms, improvement in judicial and tax systems, and introduction of transparent regulatory procedures are frequently mentioned. Strengthening investment promotion agencies is not sufficient to address these issues. Countries need to undertake nation-wide institutional reforms at various levels.

13. Sound development of financial intermediaries and technological infrastructure is often addressed in this kind of discussion. Both financial institutions and financial market play key roles in mobilising financial resources within, as well as in and out of, host countries. Hence the development of efficient financial institutions and markets may determine to a certain extent the attractiveness of a host country for investors. Technological infrastructure, particularly telecommunication facilities, is also pointed out as a key determinant for the success of investment promotion in today's world where flow of information holds the key to success.

14. Strong emphasis on education and human resources development is also an issue that is repeatedly brought up. Various studies have confirmed that the level of human capital in a host country is crucial for successful foreign direct investment (see for example World Bank 1993, 1998). The implication of this statement is a thorough re-examination of a country's labour and education policy. Bearing in mind that different investment requires different level of human resources, this task is not easy. The country may need to prepare a stock of human capital that is equipped with basic and fundamental education. At the same time, the government needs to maintain the deepening and diversification of skills at the right balance. This involves the provision of higher level education in a variety of disciplines, as well as the provision of technical skill development.

15. A business entity is susceptible to various external factors, some of which are not so formal, official or direct. Numerous stakeholders influence the way investors behave in a host economy. These stakeholders voice their interests locally as well as internationally, through various channels. Some of these concerns may be heard through official policy dialogue, while others may be taken on through enforcing peer pressures or activating civil society. Host government agencies should be aware of these various channels for influencing the behaviour of foreign investors.

Questions for discussion

1. *Do investment promotion agencies have a role to play in the formulation of investment policies?*
2. *Have they the right mix of basic institutional frameworks to attract FDI, e.g. education, management, technology, financial institutions, judicial procedures, etc. What are the priorities?*
3. *What can they do to promote dialogue between business and government authorities? Should they act as a one stop shop for investors?*

Maximising the Benefits of FDI

16. The amount of FDI may be helpful in identifying the relative attractiveness of host economies. However, it gives only a partial picture as to how and to what extent FDI influences the host economy. Examining the implications of such investment flows requires other source of information. These information are often less definite in a quantitative term and even more often subject to value judgement.

17. The host economy usually has diverse and sometimes contradictory goals in what it hopes to achieve from foreign investment promotion. The objectives of the governments for attracting FDI may include some of the following: to improve balance of payment; to increase tax revenue; to increase employment; to increase the volume of exports; to increase export competitiveness; to diversify exports; to build local technological capacity; to develop human capital; to gain access to foreign market; and to gain access to new knowledge. Numerous research have been conducted in the aforementioned studies. Research results are mixed – the benefits of FDI largely depend on the assumptions, methodology and measures adopted for the research. In short, there is no one answer whether FDI is beneficial and how its benefits should be maximised.

18. Policy makers should re-visit their development agendas and establish priorities. This would help in focusing on certain aspects of the benefits FDI may bring. It is also important to balance what the country can offer and what the country wants. A country cannot just hope to attract the most competitive investment projects, while not having the appropriate infrastructure or resources to offer. Policy makers need to understand their countries' strengths and capacities in order to realise the best investment promotion effect.

Questions for discussion

1. *What are the development priorities of participants and what role is FDI expected to play?*
2. *To what extent are performance requirements and investment incentives used in national development strategies? What has been the experience?*
3. *What are the lessons to be learnt from the case studies?*
4. *What are the future policy challenges in maximising the benefits of FDI?*

5. *What are the competitive advantages in the region in developing certain type of activities, e.g. export oriented industry*

Concluding Remarks

19. In today's world, with its accelerating rate of change, policy makers are facing a very complex task of ensuring that the benefits of FDI are maximised in a way which addresses the needs of a wide range of the local population. In order to undertake this challenging task successfully, policy makers need to have an in-depth understanding of the following issues: 1) knowledge about the market -- what foreign investors are looking for; 2) knowledge about competitors – what alternatives the foreign investors have; 3) knowledge about self as a host of an investment – strengths, weaknesses, opportunities and threats.

20. This workshop will provide a venue for reflecting on these issues, while exchanging experiences and ideas on how to deal with these complex questions, which have been briefly outlined in this paper.

Questions for discussion

1. *What conclusion would participants draw from the discussions at the workshop?*
2. *What is the direction for future co-operation?*

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