



## **FOREIGN DIRECT INVESTMENT, INVESTMENT AGREEMENTS AND ECONOMIC DEVELOPMENT: MYTHS AND REALITIES**

Yılmaz Akyüz





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# **FOREIGN DIRECT INVESTMENT, INVESTMENT AGREEMENTS AND ECONOMIC DEVELOPMENT: MYTHS AND REALITIES**

**Yılmaz Akyüz\***

**SOUTH CENTRE**

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## **ABSTRACT**

Foreign direct investment (FDI) is one of the most ambiguous and the least understood concepts in international economics. Common debate on FDI is confounded by several myths regarding its nature and impact on capital accumulation, technological progress, industrialization and growth. It is often portrayed as a long term, stable, cross-border flow of capital that adds to productive capacity, helps meet balance-of-payments shortfalls, transfers technology and management skills, and links domestic firms with wider global markets. However, none of these are intrinsic qualities of FDI. First, FDI is more about transfer and exercise of control than movement of capital. It does not always involve flows of financial capital (movements of funds through foreign exchange markets) or real capital (imports of machinery and equipment for the installation of productive capacity). Second, only the so-called greenfield investment makes a direct contribution to productive capacity and involves cross-border movement of capital goods, but it is not easy to identify from reported statistics what proportion of FDI consists of such investment as opposed to transfer of ownership of existing assets. Third, what is commonly reported as FDI contains speculative and volatile components. Fourth, the longer-term impact of FDI on the balance of payments is often negative even in countries highly successful in attracting export-oriented FDI. Finally, positive technological spillovers from FDI are not automatic but call for targeted policies of the kind that most investment agreements prohibit.



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## I. INTRODUCTION

Foreign direct investment (FDI) is perhaps one of the most ambiguous and the least understood concepts in international economics. Common debate on FDI is confounded by several myths regarding its nature and impact on capital accumulation, technological progress, industrialization and growth in emerging and developing economies (EDEs). It is often portrayed as a long term, stable, cross-border flow of capital that adds to productive capacity, helps meet balance-of-payments shortfalls, transfers technology and management skills, and links domestic firms with wider global markets.

However, none of these are intrinsic qualities of FDI. First, FDI is more about transfer and exercise of control than movement of capital. Contrary to widespread perception, it does not always involve flows of financial capital (movements of funds through foreign exchange markets) or real capital (imports of machinery and equipment for the installation of productive capacity). A large proportion of FDI does not entail cross-border capital flows but is financed from incomes generated on the existing stock of investment in host countries. Equity and loans from parent companies account for a relatively small part of recorded FDI and even a smaller part of total foreign assets controlled by transnational corporations (TNCs).

Second, only the so-called greenfield investment makes a direct contribution to productive capacity and involves cross-border movement of capital goods. But it is not easy to identify from reported statistics what proportion of FDI consists of such investment as opposed to transfer of ownership of existing firms (mergers and acquisitions, M&A). Furthermore, even when FDI is in bricks and mortar, it may not add to aggregate gross fixed capital formation (GFCF) because it may crowd out domestic investors.

Third, what is commonly known and reported as FDI contains speculative components and creates destabilizing impulses, including those due to the operation of transnational banks in host countries, which need to be controlled and managed as any other form of international capital flows.

Fourth, the immediate contribution of FDI to balance-of-payments may be positive, since it is only partly absorbed by imports of capital goods required to install production capacity. But its longer-term impact is often negative because of high import content of foreign firms and profit remittances. This is true even in countries highly successful in attracting export-oriented FDI.

Finally, superior technology and management skills of TNCs create an opportunity for the diffusion of technology and ideas. However, the competitive advantage these firms have over newcomers in EDEs can also drive them out of business. They can help EDEs integrate into global production networks, but participation in such networks also carries the risk of getting locked into low value-added activities.

These do not mean that FDI does not offer any benefits to EDEs. Rather, policy in host countries plays a key role in determining the impact of FDI in these areas. A laissez-faire approach could not yield much benefit. It may in fact do more harm than good. Successful examples are found not necessarily among EDEs that attracted more FDI, but among those which used it in the context of national industrial policy designed to shape the

evolution of specific industries through interventions. This means that EDEs need adequate policy space vis-à-vis FDI and TNCs if they are to benefit from it.

Still, the past two decades have seen a rapid liberalization of FDI regimes and erosion of policy space in EDEs vis-à-vis TNCs. This is partly due to the commitments undertaken in the WTO as part of the Agreement on Trade-Related Investment Measures (TRIMs). However, many of the more serious constraints are in practice self-inflicted through unilateral liberalization or bilateral investment treaties (BITs)<sup>1</sup> signed with more advanced economies (AEs) – a process that appears to be going ahead with full force, with the universe of investment agreements reaching 3262 at the end of 2014 (UNCTAD IPM 2015).

Unlike earlier BITs, recent agreements give significant leverage to international investors. They often include rights to establishment, the national treatment and the most-favoured-nation (MFN) clauses, broad definitions of investment and investors, fair and equitable treatment, protection from expropriation, free transfers of capital and prohibition of performance requirements. Furthermore, the reach of BITs has extended rapidly thanks to the use of the so-called Special Purpose Entities (SPEs) which allow TNCs from countries without a BIT with the destination country to make the investment through an affiliate incorporated in a third-party state with a BIT with the destination country. Many BITs include provisions that free foreign investors from the obligation of having to exhaust local legal remedies in disputes with host countries before seeking international arbitration. This, together with lack of clarity in treaty provisions, has resulted in the emergence of arbitral tribunals as lawmakers in international investment which tend to provide expansive interpretations of investment provisions in favour of investors, thereby constraining policy further and inflicting costs on host countries.

Only a few EDEs signing such BITs with AEs have significant outward FDI. Therefore, in the large majority of cases there is no reciprocity in deriving benefits from the rights and protection granted to foreign investors. Rather, most EDEs sign them on expectations that they would attract more FDI by providing foreign investors guarantees and protection, thereby accelerating growth and development. However, there is no clear evidence that BITs have a strong impact on the direction of FDI inflows. More importantly, these agreements are generally incompatible with the principal objectives of signing them because they constrain the ability of host countries to pursue policies needed to derive their full potential benefits.

This paper revisits and reviews the key issues regarding the role of FDI in industrialization and development with a view to assessing the impact of BITs. It examines if and under what conditions FDI provides a stable source of external financing, supplements domestic resources, adds to productive capacity and accelerates technological progress and industrial upgrading. It starts with an examination of the concept of FDI as officially defined and reported in order to clarify what it is about. This is followed by a discussion of the effects of FDI on capital accumulation, stability and balance-of-payments, and the policies and conditions needed to secure positive technological spillovers from foreign firms. The penultimate section assesses and compares the policy constraints implied by the WTO Agreement on TRIMs with those imposed by BITs, followed by brief policy conclusions.

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<sup>1</sup> In this paper BITs is used as a short hand for all international agreements signed outside the multilateral system that contain provisions on foreign investment and investors, including free trade and economic partnership agreements.

## II. WHAT IS FDI?

In common discussions FDI is often meant to entail capital inflows from abroad and additions to productive capacity in host countries. However, the reality is a lot more complex and the concept is a lot more ambiguous than is commonly believed. An important part of FDI does not entail cross-border capital flows and it is very difficult to identify from existing statistics what FDI really comprises.<sup>2</sup>

OECD (2008) provides global standards for direct investment statistics consistent with the related concepts and definitions of “Balance of Payments and International Investment Position Manual” of the IMF (2009). Direct investment is defined as a category of cross-border investment made by a resident in one economy (*direct investor*) with the objective of establishing a lasting interest in an enterprise (*direct investment enterprise*) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is said to be a long-term, stable relationship with the direct investment enterprise to ensure a significant degree of influence on its management. The lasting interest and a significant degree of influence is said to be evidenced when the direct investor owns at least 10 per cent of the voting power of the direct investment enterprise. Ownership below 10 per cent is treated as portfolio equity investment.

Defined in this way, FDI comprises the initial equity transaction that meets the 10 per cent threshold and all subsequent financial transactions and positions between the direct investor and the direct investment enterprise. Thus, in addition to initial equity capital outflows from the home country, it includes reinvested earnings and intercompany debt flows.

The threshold of 10 per cent is totally arbitrary and there is no compelling reason why investment in 10 per cent ownership should be less fickle than investment in 9.9 per cent. Both the OECD and the IMF recognize that in practice influence may be determined by several other factors than the extent of ownership. However, they argue that “*a strict application of a numerical guideline is recommended to define direct investment*” in order to secure international consistency and to avoid subjective judgements.<sup>3</sup>

In the official definition a direct investment enterprise is always a corporation and may also include public entities. However, contrary to a widespread perception, direct investors are not always TNCs. It could also be an individual or household, an investment fund, a government or an international organization or a non-profit institution. Certainly there are significant differences in the technology and managerial skills such diverse investors could bring to the host country. But readily available official statistics do not allow identifying them. This is one of the drawbacks of empirical studies linking aggregate FDI to various economic performance indicators in host countries such as GFDCF, productivity and growth.

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<sup>2</sup> For an earlier account of some of the issues taken up here, see Woodward (2001).

<sup>3</sup> OECD (2008: para 31). See also IMF (2009: para 6.13). Definition and measurement of FDI have changed considerably over time and varied across countries; see Lipsey (1999).

Every financial transaction after the initial acquisition of equity by the investor, that is, internal capital flows within firms, are also considered as direct investment. Thus, loans and advances from parent companies to affiliates are treated as part of direct equity rather than debt. Exceptions are made for loans between certain affiliated financial corporations, notably deposit taking corporations – international banks – on grounds that such debt is not so strongly connected to direct investment relationships. However, this may also be the case in non-financial enterprises since in practice it is not possible to identify the nature and effects of lending and borrowing between parents and affiliated corporations. Statistics do not generally give the terms and conditions of intra-company loans and advances (UNCTAD, 2009a). They are known to fluctuate much more than equity capital. They are highly susceptible to changes in short-term business conditions and their inclusion as equity capital can cause large swings in recorded FDI flows. For instance in 2012 high levels of repayment of intercompany loans to parent companies by Brazilian affiliates abroad pushed total Brazilian FDI outflows to negative figures even though there was a net equity capital investment abroad of some \$7.5 billion by Brazilian parent companies (UNCTAD WIR, 2013).

While initial equity investment and intercompany loans constitute capital inflows to the host country, this is not the case for retained earnings. In FDI statistics these are imputed as being payable to the owners, to be reinvested as an increase in their equity. Thus, they are assumed to be used for lasting investment in the existing or new productive assets. In balance-of-payments they are first recorded as investment income payments in the current account and then as offsetting inflows of direct equity investment in the capital and financial account.

Retained earnings constitute a significant part of statistically measured FDI inflows. Historically, equity capital outflows and net debt from parent companies are relatively small parts of US outflows of direct investment while the rest comes from retained earnings. In the post war period until the mid-1990s the latter accounted for no less than one half of US outward direct investment (Lipsey 1999). It was even higher in more recent years because of growth of the US outward FDI stock. In 2008, retained earnings constituted 60 per cent of outward FDI stock for non-bank affiliates of US non-bank corporations (Table 1). Globally, in 2011 they accounted for 30 per cent of total FDI flows. This proportion was even higher for FDI in EDEs; in the same year, half of the earnings on FDI stock in EDEs were retained, financing about 40 per cent of total inward foreign direct investment in these economies (UNCTAD WIR 2013).

Clearly, when financed from earnings generated in host countries, FDI does not constitute an autonomous source of external financing. Given that retained earnings constitute an important component of total recorded FDI, the notion that FDI is functionally indistinguishable from fresh capital inflows and represents a flow of foreign resources crossing the borders of two countries has no validity, as long noted by Vernon (1999). Equity and loans from parent companies account for a relatively small part of recorded FDI and an even smaller part of total foreign assets controlled by them.

This is illustrated in Table 1 for the majority-owned foreign non-bank affiliates of US non-bank corporations. Figures for 1989 are estimates at current cost given by Feldstein (1994) whereas those for 2008 are based on the 2008 benchmark survey of the US Bureau of Economic Analysis (BOEA 2008), using the same methodology as Feldstein (1994). In both years, FDI as defined in the balance-of-payments exceeds by a large margin not only equity

and loans from parent companies, but also total net external finance from all US sources because of retained profits.<sup>4</sup> More importantly, the value of assets of US affiliates is significantly greater than net finance from US sources because of equity and debt from non-US sources and the share of non-US sources in retained profits of majority-owned US affiliates. In 2008, total assets controlled by US affiliates were 8.6 times the net external finance from US sources (equity and debt from US parents and other US investors) and 3.8 times the stock of US outward FDI at current cost as conventionally defined (that is, including unrequited profits).

**Table 1: Outward FDI and Value of Assets of US Non-Bank Foreign Affiliates**  
(Billions of US dollars)

	1989	2008
<b>FDI (US parents)</b>	<b>452</b>	<b>4376</b>
Equity	202	1638
Debt	25	130
Retained earnings	225	2608
<b>Other US investors</b>	<b>24</b>	<b>146</b>
Equity	1	3
Debt	22	138
Retained earnings	1	5
<b>Net external finance from US sources<sup>a</sup></b>	<b>250</b>	<b>1909</b>
<b>Net finance from US sources<sup>b</sup></b>	<b>476</b>	<b>4522</b>
<b>Non-US finance</b>	<b>761</b>	<b>11910</b>
Equity	92	2741
Debt	567	4806
Retained earnings	102	4363
<b>Value of assets of US affiliates<sup>c</sup></b>	<b>1237</b>	<b>16432</b>

**Source:** 1989 figures from Feldstein (1994). 2008 figures are estimates from BOEA 2008) using the same method as Feldstein.

a: Equity and debt from US parents and other US investors

b: FDI plus other US investors.

c: Net finance from US sources plus non-US finance.

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<sup>4</sup> Feldstein (1994) distinguishes among several definitions of outward FDI. The narrowest definition, net external finance from US sources, includes only outflows of equity and debt from US parents and other US sources. Net finance from US sources is a broader definition and includes, in addition, retained earnings due to US parents and other US investors. The broadest concept refers to total assets controlled by US parents, that is, value of assets of US affiliates, and includes, in addition, equity and debt finance from non-US sources and the share of non-US equity investors in retained earnings.

### **III. FDI AND DOMESTIC INVESTMENT**

As officially defined, FDI can take three main forms. The first is greenfield investment which involves creating a subsidiary from scratch with fresh capital by one or more non-resident investors. The second is cross-border M&A which relate to existing company structures. Cross-border mergers arise when resident and non-resident companies agree to combine into a single operation. Acquisitions involve the purchase of existing companies fully or partly by a non-resident company or a group of companies; that is, a transfer of ownership from residents to non-residents of 10 per cent or more of voting stock of an existing company. The third is the expansion of production capacity of existing firms partly or fully owned by non-residents through injection of fresh money, including loans from parent companies.

When FDI is in the form of acquisition of existing public or private assets, it has no direct contribution to domestic capital formation although changes in ownership can give rise to productivity gains, may be followed by new investment by the direct investor or may stimulate domestic investment that would not have otherwise taken place. Cross-border privatization could also add to domestic capital accumulation if the proceeds are used for investment. However, these all depend on several other factors, including host country policies. Moreover, such spillovers may also be generated by greenfield FDI. Thus, M&A cannot be treated at par with the other two components of FDI which directly add to productive capacity in host countries.

These three categories of FDI are not separately identified in the existing statistics on FDI provided by the OECD and the IMF.<sup>5</sup> UNCTAD provides data on M&A as well as greenfield “investment projects” from 2003 onwards which refer to capital expenditure planned by the investor at the time of the announcement. It is recognized that investment projects data “can be substantially different from the official FDI data as companies can raise capital locally and phase their investments over time, and the project may be cancelled or may not start in the year when it is announced” (UNCTAD WIR 2014: 33, note 1). A comparison of reported FDI inflows with the sum total of M&A and greenfield projects shows considerable variations over 2003-13. For AEs, figures on total FDI exceed the sum total of the figures on greenfield projects and M&A for every year except 2005. For EDEs, this is the case since 2010 and in some years the discrepancy is as high as 40 per cent of reported FDI figures. Given the global economic downturn after 2007, investment plans are unlikely to have been exceeded to the extent to account for the discrepancy. This strongly suggests that reported FDI figures contain items that may not really qualify as direct investment.

The existing statistical measures cannot always identify the use made of unrequited earnings and loans from parents. It is known that they are extensively used to accumulate record levels of cash and other liquid assets, rather than reinvested in productive capacity (UNCTAD WIR 2013). Certainly, any industrial or commercial enterprise needs to hold liquid capital in order to support its core activities for the production and marketing of goods

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<sup>5</sup> The fourth edition of OECD Benchmark Definition of FDI contains an updated benchmark definition and provides guidance on how to compile FDI by type and distinguish M&A (OECD 2008: 141-42). However, collection of data on FDI from member countries according to the new guidelines started only in September 2014 and will not be available before the second quarter of 2015.

and services. But it is very difficult to identify from official statistics the proportion of recorded equity capital held in such assets or whether they serve to support core activities rather than constitute an independent source of financial income and speculative capital gains.

All these difficulties in interpreting the reported FDI data as investment in productive capacity are also recognized by UNCTAD (WIR 2014: 149): “FDI flows do not always translate into equivalent capital expenditures, especially where they are driven by retained earnings or by transactions such as mergers and acquisitions (M&As), although some M&A transactions such as brownfield investment in agriculture do result in significant capital expenditure. FDI can contain short-term, relatively volatile components, such as ‘hot money’ or investments in real estate.”

The contribution of FDI to GFCF depends not only on whether it represents additional capital spending on productive capacity rather than transfer of ownership or portfolio investment, but also on its impact on domestic capital accumulation – that is, whether it crowds in or crowds out domestic investment. The impact can occur in various channels. FDI inflows attracted by privatization could allow public investment to be raised. Again, it can affect domestic investment by easing the balance-of-payments constraint. Whether FDI crowds in or crowds out domestic investors also depends on the externalities and spillovers generated by foreign firms. They can stimulate domestic investment if they help improve overall economic performance through linkages with the domestic industry and technological and managerial spillovers. However, such benefits are not automatic. In the absence of deliberate and effective policies to generate positive spillovers, financial and technological strengths of these firms can simply crowd out domestic investors.

The empirical evidence on the impact of FDI on aggregate domestic investment is inconclusive and the impact is often related to other variables including institutions and policy (Akyüz 2006; Morrissey and Udomkerdmongkol 2012; Farla *et al.* 2013). Results also differ across regions with East Asian EDEs mostly showing crowding-in while Latin America crowding-out.<sup>6</sup> Most of these studies do not distinguish between acquisition of existing assets and greenfield investment. A study examining the impact of M&A separately concludes that M&A-related FDI is not only less beneficial than greenfield investment, but has also adverse effect on accumulation and growth (Nanda 2009).

The evidence of the impact of outward FDI on domestic investment in home countries is also mixed. One of the first studies on this by Feldstein (1994) using data from the US for the 1970s and 1980s concluded that outbound FDI reduced domestic investment about dollar for dollar whereas inbound FDI raised domestic investment by the same magnitude. A more recent study on OECD countries using data from the 1980s and 1990s came to the same conclusion for aggregate domestic investment and outward FDI (Desai *et al.* 2005). However, when the analysis was confined to domestic and outward investment by TNCs, investment by American multinationals and their foreign affiliates appeared complimentary. Research also suggests that the relation between domestic investment and outward FDI may be sector specific, with those with strong R&D components appearing to be complimentary

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<sup>6</sup> Looking at Africa, Asia and Latin America, Agosin and Machado (2005) finds that the impact of FDI on domestic investment is at best neutral in all regions, with Latin America showing crowding-out effect. See also Ernst (2005) on crowding out in the three largest economies of Latin America. The evidence provided by Mutenyo *et al.* (2010) suggests that FDI also crowds out private investment in sub-Saharan Africa.

compared to efficiency seeking FDI (Goedegebuure 2006). With increased outward FDI from some major EDEs, attention has recently turned to the impact of such investment on domestic capital accumulation in these economies. A study using aggregate domestic investment and outward FDI data from 121 countries, including both developing and transition economies, over the period 1990-2010 found that outward FDI in these countries had a negative effect on domestic investment (Al-Sadig 2013).

The rapid growth of global FDI in the past three decades appears to have led not so much to an acceleration of global capital accumulation as to a reallocation of production facilities, jobs and ownership across different countries. For the world economy as a whole, total FDI inflows as a proportion of GDP increased by more than three-fold since the 1980s while the investment ratio declined over the same period (Table 2). During this period FDI inflows grew rapidly in both AEs and EDEs, but investment fell in the former while rising in the latter. In AEs in both the 1990s and 2000s, higher FDI inflows were associated with lower domestic capital accumulation. While the acceleration of FDI inflows to EDEs was associated with an increase in domestic investment in the new millennium, this was not the case in the 1990s.

In the 1990s privatization of public assets played an important role in the increase in FDI inflows, particularly in Latin America which received two-thirds of total FDI inflows to EDEs linked to privatization (UNCTAD TDR 1999). After a series of financial crises in EDEs starting in the mid-1990s, most forms of capital inflows, notably bank lending, fell sharply, but FDI kept up. An important factor was foreign acquisition of companies of EDEs hit by the crises. This happened particularly during the Asian crisis where massive flight of short-term capital and sale of foreign equity holdings were accompanied by a wave of FDI inflows in the form of foreign acquisition of Asian firms. Collapse of currencies and asset price deflation, together with the pressure from the IMF to abandon policies unfavourable to foreign ownership, created opportunities for TNCs to buy Asian companies at fire-sale prices (Krugman 2000). Indeed, cross-border M&A as a percent of total FDI peaked during the recurrent crises in EDEs at the end of the 1990s and early 2000s (Chart 1). Foreign acquisitions at times of crises in host countries are driven mainly by non-financial acquirers targeting firms in the same industry, thereby concentrating market power in TNCs at the expense of national companies of EDEs (Alquist *et al.* 2013).

This suggests that the economic conditions that attract foreign enterprises may not always be conducive to faster capital formation and that the two sets of investment decisions may be driven by different considerations. Indeed, the generalized surge in FDI inflows to EDEs in the 1990s was not always associated with a concomitant increase in domestic capital formation. In Latin America there was a widespread association of increased FDI with reduced fixed capital formation; for the region as a whole FDI as a proportion of GDP was higher in the 1990s than in the 1980s by more than 1.7 percentage points, but the share of GFCF in GDP was lower by some 0.6 percentage points (UNCTAD TDR 2003). In all major Latin American economies FDI as a proportion of GDP rose strongly while GFCF either stagnated or fell between the two periods (Chart 2). It is also notable that the inverse association between GFCF and FDI is found not only in countries where an important part of FDI was in the form of M&A, but also in Mexico where there was considerable greenfield investment stimulated by NAFTA. Again in several countries in Africa, FDI and GFCF moved in opposite directions. By contrast in none of the rapidly growing East Asian NIEs was rising FDI associated with falling GFCF.

**Table 2: Investment and FDI**

(*Per cent of GDP*)

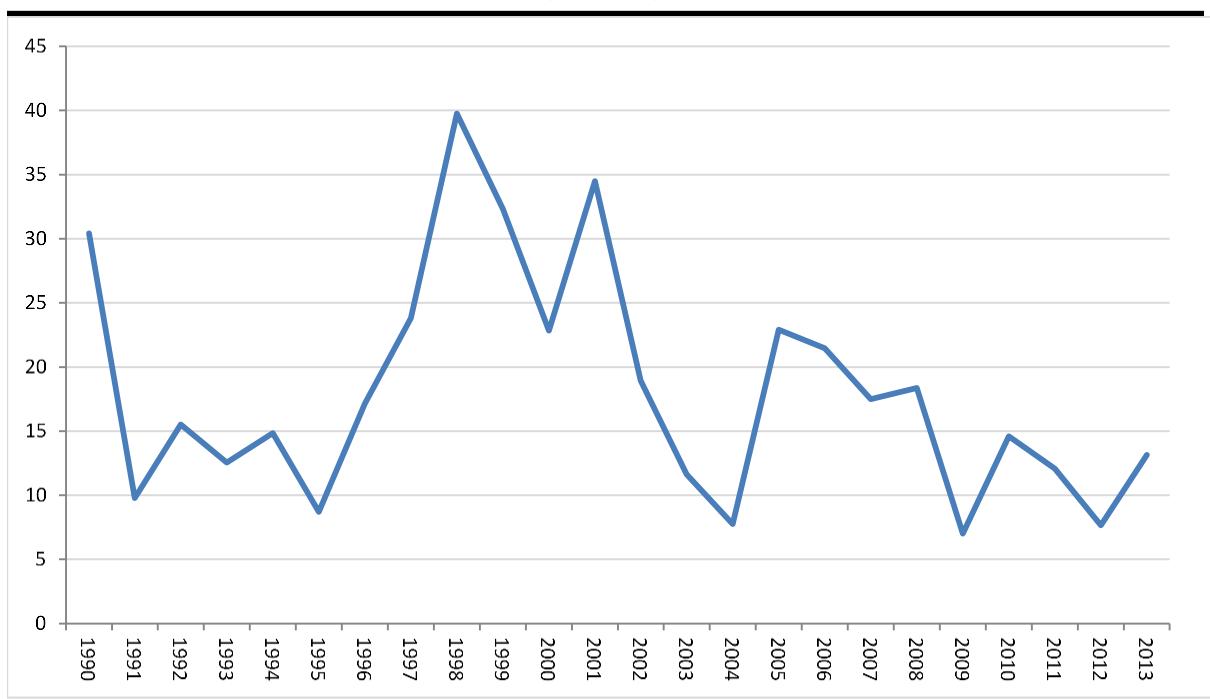
	Investment <sup>a</sup>			FDI Inflows		
	1981-1990	1991-2000	2001-2013	1981-1990	1991-2000	2001-2013
World	24.4	23.4	23.6	0.64	1.71	2.29
AEs	24.3	23.2	21.3	0.65	1.57	1.90
EDEs	24.4	24.4	28.4	0.59	2.19	3.12

*Source:* IMF *World Economic Outlook* (October 2014) and UNCTAD *FDI* database.

a: Includes inventories

**Chart 1: Share of Cross-border M&A as per cent of total FDI inflows in Developing Countries<sup>a</sup>**

(*Per cent*)

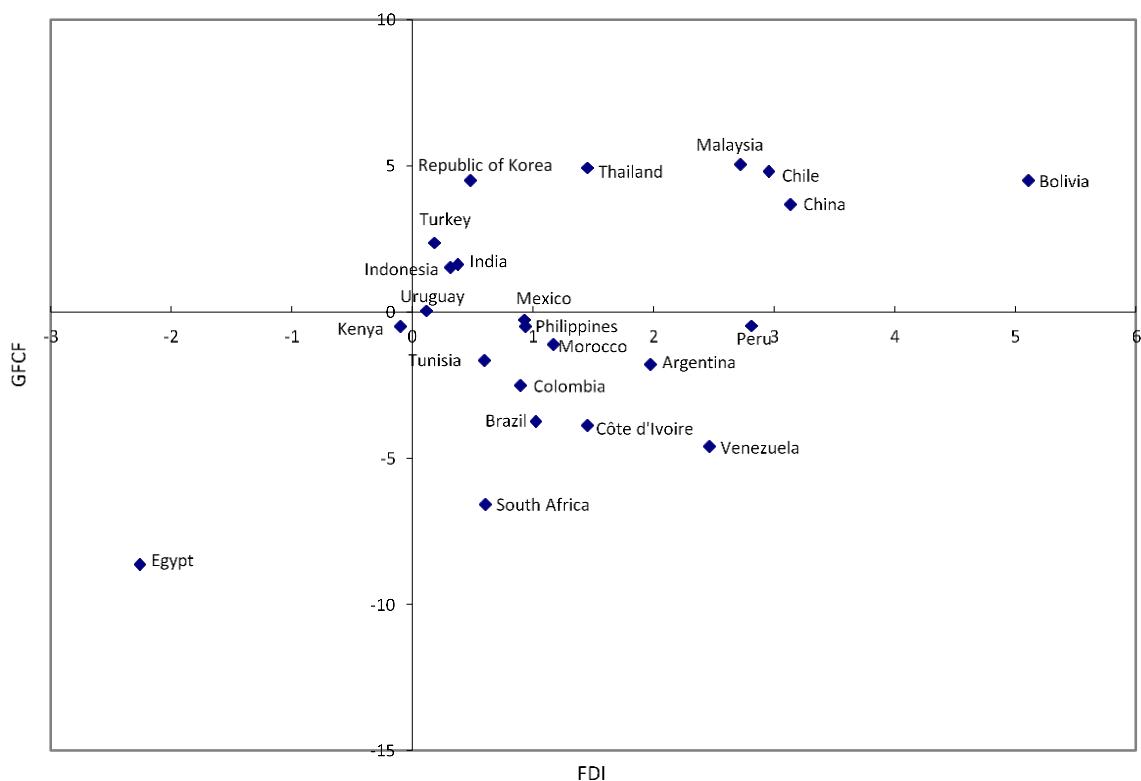


*Source:* UNCTAD *WIR* (2014).

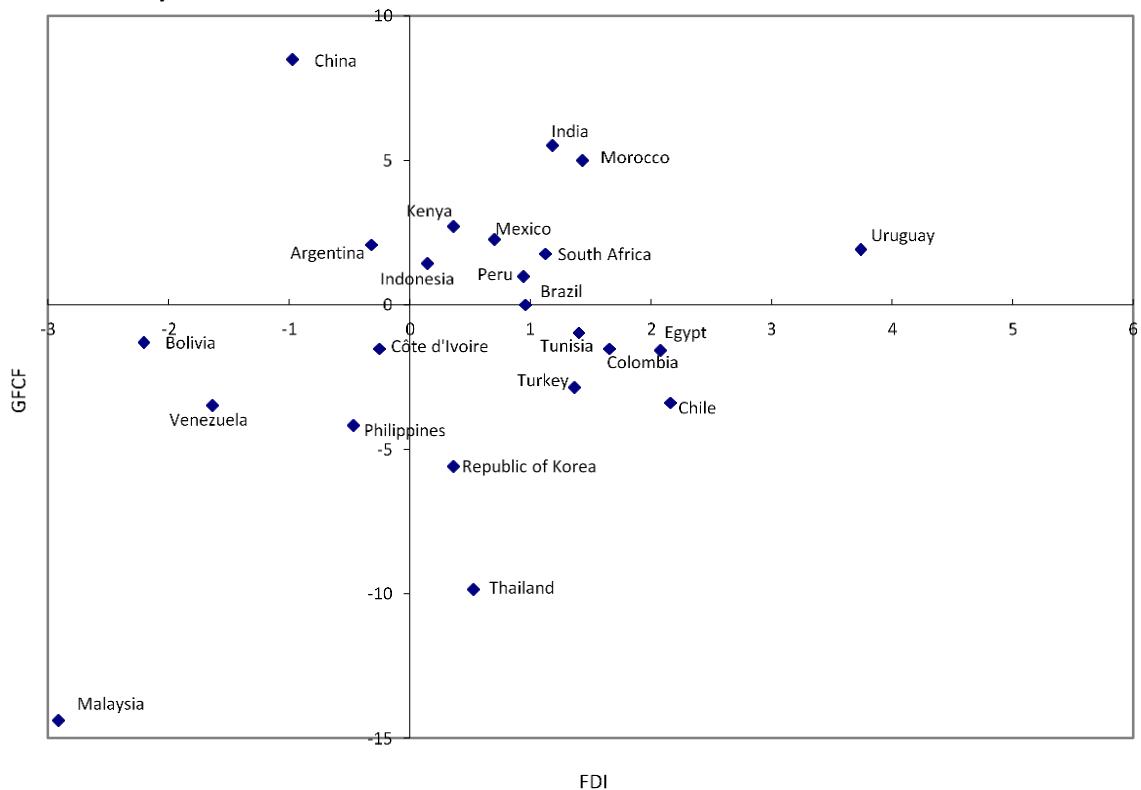
a: excludes China

**Chart 2: Changes in FDI Inflows and Domestic GFCF in Selected Emerging Economies**  
*(Per cent of GDP)*

**1990-2000 compared to 1980-1990:**



**2000–2012 compared to 1990–2000:**



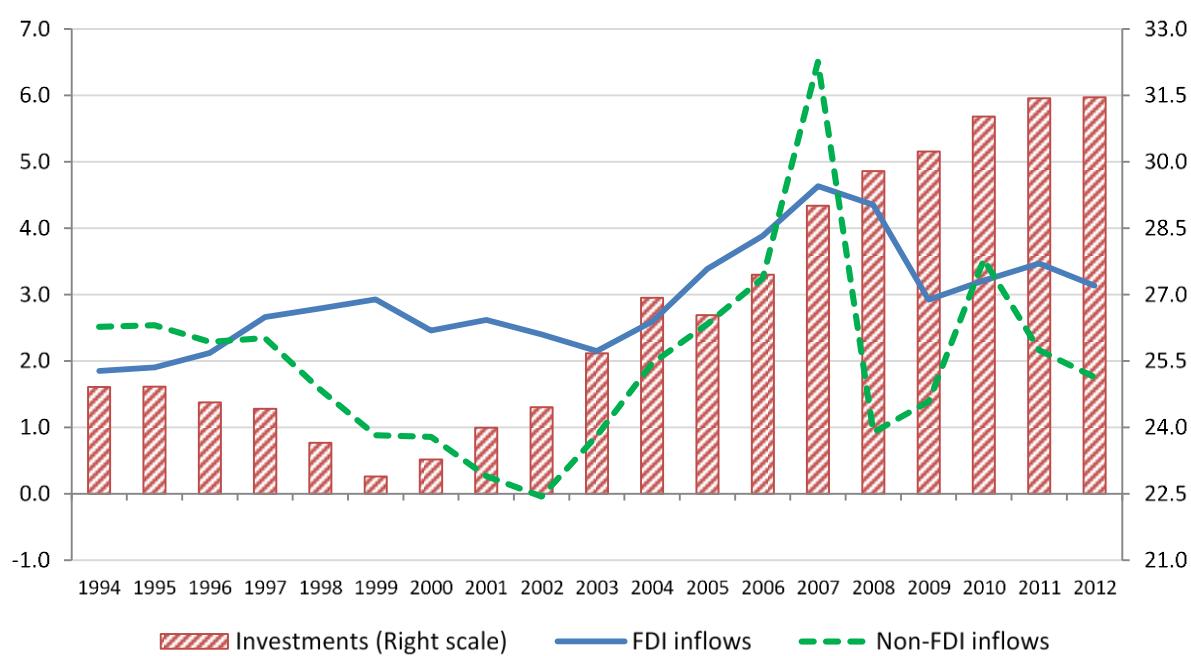
**Source:** UNCTADstat.

In the new millennium, in EDEs as a whole, both FDI inflows and investment as a percentage of GDP increased strongly until the global crisis, but they departed subsequently, with FDI falling while investment kept up thanks largely to fiscal stimulus packages introduced in response to fallouts from the crisis (Chart 3). In 2012 they were both significantly higher than the levels recorded in the early years of the century. There is, however, considerable diversity among countries. In more than half of the countries which enjoyed booms in FDI inflows, GFCF fell or stagnated, including Brazil, Korea, Turkey and Thailand (Chart 2). In China FDI inflows declined mainly because of contraction in its export markets while GFCF increased sharply because of the policy response of the government to fallouts from the crisis with a massive investment package. Among the East Asian countries severely hit by the 1997 crisis, only Indonesia saw an increase in both FDI and GFCF in the 2000s compared to the 1990s while Malaysia experienced a sharp contraction in both.

The examination of the movements of capital inflows to EDEs and domestic investment over the past two decades shows that FDI tends to move more closely with non-FDI flows than with domestic investment (Chart 3). From the mid-1990s until the end of the decade, there was an inverse correlation between FDI and domestic investment. After the Asian crisis in 1997 until 2002, domestic investment and gross non-FDI capital inflows followed a downward trend while direct investment inflows kept up thanks, in part, to fire-sale FDI in crisis-hit countries noted above. After 2002, FDI and non-FDI inflows followed a similar path, rising strongly until the Lehman turmoil, declining sharply during 2008-09, and recovering subsequently but remaining below their pre-crisis levels.

Generally, FDI seems to follow rather than lead domestic investment. Evidence from a study on a large sample of countries over 1984-2004 indeed shows that lagged domestic investment has a strong influence on FDI inflows to the host economy (Lautier and Moreau 2012). On the other hand, FDI and non-FDI inflows are more closely connected than is commonly believed. This is partly because, like portfolio flows, part of FDI, property investment, is also driven by financial bubbles. Second, global liquidity conditions have an important impact on FDI because assets acquired by TNCs are often leveraged. This is true not only for corporations from AEs but also from major EDEs (Akyüz 2014). Financial cycles also exert a strong influence on profits of TNCs which constitute an important source of FDI. As noted by the BIS (1998: 28) “short-term movements in FDI flows are highly procyclical, mainly reflecting the influence of reinvestment of retained earnings.” These influences have been particularly evident in the new millennium with FDI moving closely with non-FDI inflows. By contrast, several EDEs which enjoyed surges in both types of inflows experienced falling or stagnant domestic investment rates and deindustrialization (Akyüz 2012; Naudé 2013 *et al.*).

**Chart 3: International Capital Inflows and Investment in EDEs<sup>a</sup>**  
*(Per cent of GDP)*



**Source:** IMF World Economic Outlook Database (October 2014) and Balance of Payments Statistics (BOP), World and Regional Aggregates.

a: EDEs include emerging markets and developing countries as defined by the IMF. Investment includes inventories.

#### **IV. IMPACT ON STABILITY**

It is widely held that FDI constitutes a stable source of finance for balance-of-payments shortfalls. On this view, because FDI is largely fixed in illiquid assets and reflects “lasting interest” by the investor, the likelihood of direct investment to exit rapidly at times of deteriorations in global liquidity conditions and risk appetite is much more limited than other forms of capital inflows. In other words, “it is bolted down and cannot leave so easily at the first sign of trouble” (Hausmann and Fernández-Arias 2000: 3). Consequently, it is argued, they do not pose a serious threat to macroeconomic and financial stability in EDEs.

This account is misleading because it ignores certain features of FDI and TNCs which can induce as much instability in balance-of-payments and domestic asset and credit markets as portfolio investment and investors. Furthermore, many of the changes in financial markets that have facilitated international capital movements have not only increased the mobility of FDI, but also made it difficult to assess its stability.

First, recorded FDI statistics do not always allow identifying the stability of its various components and hence the destabilizing impulses they may generate. While FDI inflows do not always involve inflows of financial capital, their exit always implies outflows of funds through the foreign exchange market. By convention, retained earnings are recorded as additions to equity capital, but in reality they may well be used to acquire financial assets or repatriated as portfolio outflows. Further, financial transactions can accomplish a reversal of FDI. A foreign affiliate can borrow in the host country to lend the money back to the parent company or the parent can recall intercompany debt (Loungani and Razin 2001). More generally, what may get recorded as portfolio outflows may well be outflows of FDI in disguise:

Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows (Claessen *et al.* 1993: 22).

Second, FDI inflows can undergo temporary surges as a result of discovery of large reserves of oil and minerals, widespread privatization, rapid liberalization or favourable political changes. A glut in the foreign exchange market resulting from a one-off surge in FDI inflows could generate unsustainable currency appreciations in much the same way as surges in any other forms of capital inflows, contrary to the widespread fallacy that it is only short-term capital inflows that can lead to such an outcome. The impact on the currency could be particularly strong when FDI inflows involve acquisition of existing assets rather than greenfield investment since the latter involves imports of capital goods required to install production capacity.

Third, FDI includes components such as real estate investment that are often driven by speculative motivations and susceptible to sharp fluctuations. This has led the IMF (2009: 105) to suggest that “[b]ecause it may have different motivations and economic impact from other direct investment, if real estate investment is significant, compilers may wish to publish data on such investment separately on a supplementary basis.” Cross-border property

acquisitions have no doubt played an important role in the increased volatility and gyration of property prices in the past two decades in several countries. Historical data on housing transactions in London shows significant foreign effect on house prices and volume of transactions (Badarinza and Ramadorai 2014). The recent recovery in house prices in London is predominantly due to growth in foreign demand (Property Wire 2014b). Foreign purchases played an important role in the build-up of the Spain property bubble in the run up to the crisis in 2008. Hopes are now pinned once again on foreign demand for the recovery of the housing market in Spain as sales to foreigners increased almost 209 per cent in the 12 months ending in October 2014 with the share of foreigners hitting a new high of 13 per cent of the market (Taylor Wimpey 2014). In Turkey too foreign investment has been an important driver of the ongoing bubble in the property market (Property Wire 2014a).

Fourth, the “lasting interest” the foreign direct investors are said to have with direct investment enterprise does not always translate into a long-term commitment of that enterprise to the host country. Investment in bricks and mortar can be highly footloose, particularly in fragmented production segments organized by TNCs as part of international production networks for manufactured products. It is less likely to happen when investment is resource seeking, but even then the discovery of more profitable reserves elsewhere could lead to migration of FDI. The emergence of lower cost locations for manufacturing production for global markets can result in shifts of location of production particularly when policies fail to lock TNCs into the economy with strong linkages to local firms and succeed in getting them to upgrade and move to higher echelons in the production chains they control. This is seen in East Asia, notably in Malaysia, where a number of plants producing electronics left for China as the latter emerged as a more attractive location for production for international markets (Ernst 2004). Again certain TNCs in electronics left Mexican maquiladoras for China and some other Asian countries, and Chinese inward FDI is found to have had a negative impact on FDI inflows to Mexico and Colombia, particularly after China joined the WTO (Zarsky and Gallagher 2008; García-Herrero and Santabárbara 2007). Much of the FDI in Ireland also appears to be footloose, encouraged by its entry to the EU and special incentives (Campa and Cull 2013).

Finally, and perhaps more importantly, foreign banks established in EDEs can be a major source of financial instability. There is now a significant presence of such banks in EDEs. Their share in banking in these economies doubled between 1995 and 2009 to reach 50 per cent in the latter year, compared to 20 per cent in OECD countries. A large majority of them are from AEs (Claessens and van Horen 2012). These banks tend to cream-skim the banking sector in EDEs, picking the best creditors and depositors. They are better able to benefit from regulatory arbitrage by shifting operations back and forth between the home and host countries. More importantly, contrary to the long-held orthodox view that they enhance the resilience of EDEs to external financial shocks, it is now widely recognized that the extensive presence of foreign banks can aggravate their financial fragility and vulnerability to financial shocks. As pointed out in an IMF Staff Discussion Note, cross border banking groups “are highly interconnected internationally and may expose individual countries to the risk that shocks in other countries will spill over into their domestic financial systems” (Fiechter *et al.*, 2011: 5).

These banks are known to have been instrumental in the rapid accumulation of external debt and balance-of-payments fragility in the Eurozone periphery in the run up to the crisis. Again during the recent surge in capital inflows to EDEs, they have been extensively engaged in carry-trade-like intermediations, benefiting from large interest-rate arbitrage

margins between reserve-issuing AEs and EDEs and currency appreciations in the latter. They were also seen to act as a conduit of financial instability in AEs during the global crisis, transmitting credit crunches from home to host countries, cutting lending more than domestically-owned banks and withdrawing earlier than domestic banks from the interbank market. They are generally slower than domestic banks in adjusting their lending to changes in host country monetary policy, thereby impairing its effectiveness. During the EZ crisis foreign affiliates in many European emerging economies acted as conduits of capital outflows in support of their parent banks in the Eurozone core, leading to depletion of reserves and putting pressures on the currencies of host countries (Akyüz 2014).

## V. IMPACT ON BALANCE-OF-PAYMENTS

### V.I. *Net transfers*

Most EDEs, particularly those with chronic current account deficits and excessive dependence on foreign capital regard FDI mainly as a source of external financing, rather than as an instrument of industrialization and development. In closing the external financing gap FDI is preferred to debt-creating inflows because it does not entail fixed obligations besides being more stable.

However, FDI can also result in considerable outflows in income remittances and hence exert pressure on the balance-of-payments in much the same way as debt obligations. A measure of this pressure is net transfers – that is, the difference between net inflows of FDI and FDI-related payments abroad including profits, royalties, licence fees, wage remittances and interest paid on loans from parent companies. This concept is akin to that of net transfers on debt obligations widely discussed during the Latin American debt crisis. If income transfers abroad exceed net inflows of FDI in any particular year, then the gap would have to be closed either by generating a current account surplus or using reserves or borrowing abroad.<sup>7</sup>

At the early stages of involvement of EDEs with TNCs, the stock of FDI tends to be small relative to new inflows. But over time inflows tend to fall relative to the stock. In other words, initially the growth rate of the FDI stock is likely to exceed the rate of return on it and net transfers on FDI would be positive. However, as the stock of FDI increases its growth rate tends to decline, eventually falling below the rate of return on existing FDI stocks, resulting in net negative transfers. Clearly, the higher the rate of return on foreign capital stock, the sooner the host country may face net negative transfers on FDI.

Countries with a long history of TNCs involvement and hence a relatively large stock of foreign capital tend to face negative transfers. A developing economy with abundant labour and good infrastructure may start attracting large amounts of FDI for the production of labour intensive manufactures for global markets, but over time FDI inflows are likely to level off as surplus labour gets exhausted and wages start rising. The emergence of low cost locations can also lead to diversion of FDI, widening the gap between new inflows and income payments on foreign capital stock. Discovery of rich oil and mineral reserves can give rise to a strong surge in FDI which cannot be maintained over time. In such countries the growth rate of foreign capital stock can fall rapidly and negative net transfers can appear in a relatively short time after an initial surge in foreign investment. Again, a sudden opening up of an economy could lead to a one-off boom in FDI inflows.

The long-term trend in the growth rate of FDI stock in EDEs is downward, albeit showing large swings and boom-bust cycles (Chart 4). This is clearly seen if periods of extreme instability are excluded. The average annual growth rate was around 14 per cent during the first half of the 1990s, before the recurrent crises in EDEs. It fell to 11.3 per cent during 2002-07 and again to less than 10 per cent during 2010-13.

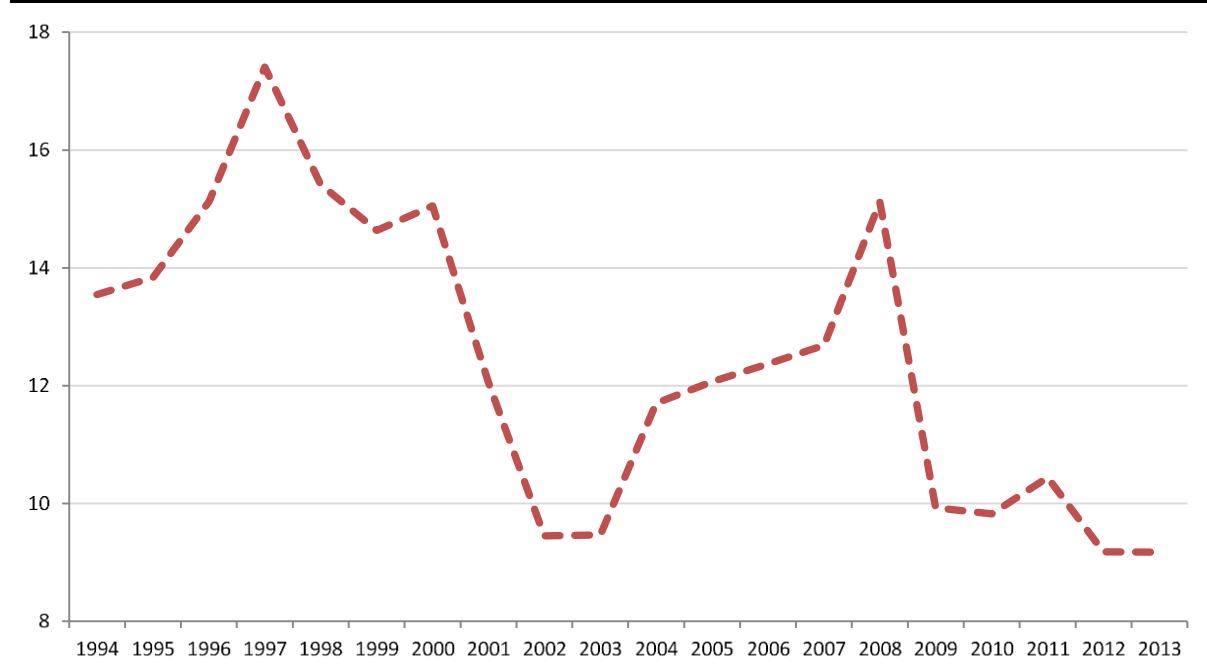
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<sup>7</sup> This holds whether or not profits are remitted since retained earnings are recorded as FDI inflows.

**Chart 4: Inward FDI Investment in EDEs**

Ratio of FDI Flows to FDI Stocks

(Per cent)



**Source:** UNCTADstats.

**Table 3: Net Transfers on FDI in Selected EDEs**

Ratio of Cumulative Profit Payments to Cumulative FDI Inflows: 2000-2013

Ranking	Country	Ratio	Ranking	Country	Ratio	Ranking	Country	Ratio
1	Algeria	3.09	10	Congo, Republic of	1.17	19	Colombia	0.83
2	Nigeria	2.09	11	Philippines	1.07	20	Zambia	0.73
3	Malaysia	1.73	12	Indonesia	1.06	21	China	0.52
4	Thailand	1.54	13	Chile	1.06	22	India	0.49
5	Singapore	1.43	14	Russian Federation	0.99	23	Brazil	0.43
6	Libya	1.38	15	Tunisia	0.95	24	Mexico	0.40
7	Cote d'Ivoire	1.31	16	Sudan	0.92	25	Kenya	0.39
8	Peru	1.21	17	Argentina	0.90	26	Egypt	0.39
9	South Africa	1.20	18	Korea	0.88	27	Turkey	0.18

**Source:** IMF BOP.

**Note:** For 2000-2004 data are based on BPM5 and for 2005-2013 on BPM6.

Indonesia: 2003-2013; Peru: 2007-2013; Thailand: 2001-2012; Algeria: 2005-2013; Congo: 2000-2007; Cote d'Ivoire: 2000-2010; Libya: 2000-2010; Singapore: estimates for 2002-12 based on national data; Sudan: 2002-2013.

For EDEs as a whole, on average, annual inflows of FDI exceed income payments on FDI stocks. However, there are considerable inter-country variations. This is shown in Table 3 in terms of a comparison of cumulative income payments on the stock of FDI and cumulative inflows over 2000-13 for a number of EDEs, including major recipients of FDI. In half of the countries in the table, total income payments exceeded total new inflows over that period. Two African oil exporters top the list in terms of negative net transfers.<sup>8</sup> They are followed by three South East Asian countries that relied extensively on FDI from the early stages of their development. By contrast, the ratio of profits remittances to new inflows is low in countries which received large inflows of FDI relative to the initial stock in the more recent period, including Brazil, China and Turkey.

Of countries with negative net transfers Malaysia has a long history of involvement with TNCs, often cited in the 1990s as an example of how to sustain rapid growth by attracting large inflows of export-oriented FDI. On both per capita basis and relative to GDP it had one of the largest FDI stocks and flows in the developing world in the 1990s (UNCTAD TDR 1997: Table 32). However, the momentum could not be kept up and the country experienced a sharp drop in FDI inflows in the new millennium (Chart 2) with the emergence of low cost venues and the failure to upgrade rapidly while income transfers on FDI stock have kept up with full force.<sup>9</sup> In Malaysia manufactures no longer dominate export earnings if measured in value-added terms since they have much higher import contents than commodities (Akyüz 2012).

China, as a major recipient of FDI still maintains a high level of FDI inflows as a proportion of its inward FDI stock not only in comparison with Malaysia but also the rest of the developing world (Chart 5). However, FDI inflows to China have been falling relative to the stock. This suggests that profit opportunities for foreign investors in labour intensive sectors and processes for production for markets abroad are being exhausted. To avoid a sharp drop in FDI inflows of the kind experienced by Malaysia, higher value-added sectors should become attractive to foreign investors and this depends largely on its success in industrial upgrading.

Some countries with negative net transfers such as Nigeria, Algeria, Malaysia and Libya have had relatively large trade surpluses in recent years to help them to meet negative net transfers on FDI. But these surpluses have been falling rapidly with the end of the commodity boom, resulting in deterioration in the current account. In Malaysia and Nigeria the current account surplus fell from double digit figures during 2006-08 to 2-3 per cent in 2015. In Libya and Algeria, large surpluses of earlier years have already disappeared and these countries are now running large current account deficits. Most others with negative net transfers in Table 3 also run deficits on trade in goods and services. This means that they need to rely on reserves or borrow abroad or attract highly volatile portfolio inflows in order to balance their external accounts. If reserves prove inadequate and international lending and investment are cut back, they can then face liquidity problems because of large income outflows on the stock of FDI.

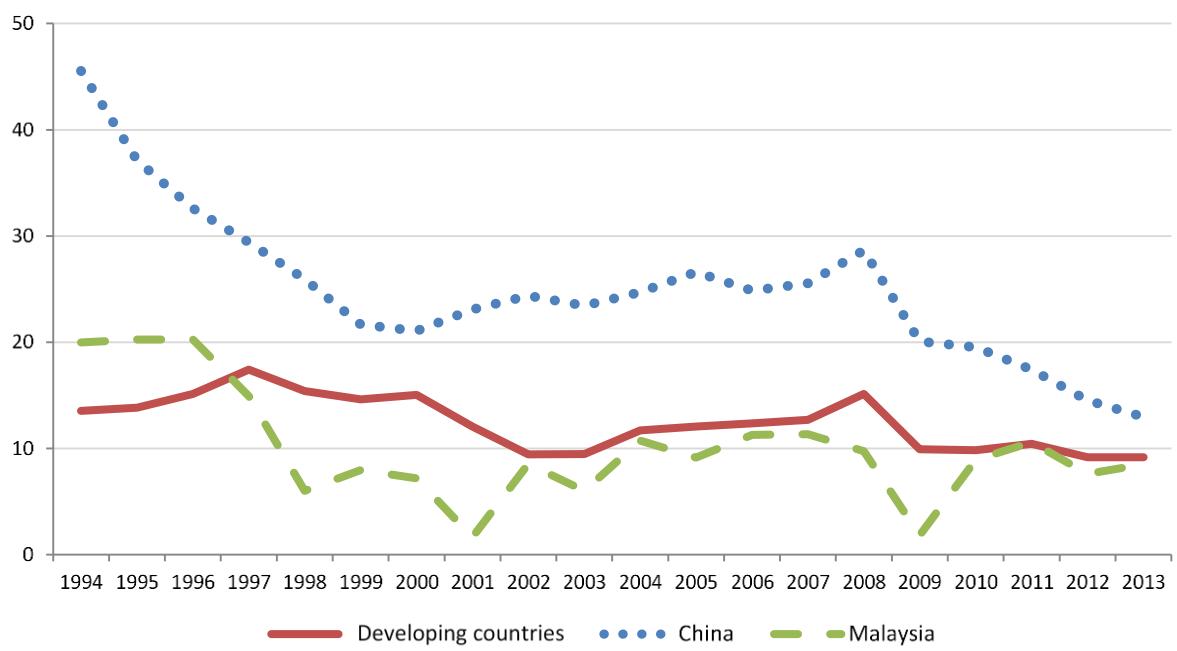
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<sup>8</sup> According to Sumner *et al.* (2009: 3) in “Sub Saharan Africa up to 90 per cent of FDI inflows are lost in profit repatriation.” However, since foreign firms in the primary sector are highly export-oriented, their current account impact, discussed in the subsequent section, is still positive.

<sup>9</sup> Malaysia also ran negative net transfers in the late 1980s, but in the 1990s FDI inflows accelerated significantly, exceeding income payments on the stock – see Woodward (2001: Chapter 11).

**Chart 5: FDI Inflows and Stocks in China and Malaysia**

Ratio of FDI Flows to FDI Stocks  
(Per cent)



**Source:** UNCTADstats.

In addition to officially recorded income transfers, TNCs are known to be extensively involved in illicit financial outflows from EDEs through such practices as tax evasion, trade mis-pricing and transfer pricing.<sup>10</sup> Various estimates show that these account for the bulk of illicit outflows from EDEs. According to a recent report by a panel chaired by former president of South Africa, Thambo Mbeki, the continent has been losing \$50-\$60 billion per annum in illicit financial outflows in recent years (UNECA 2014). About 60 per cent of these originate from the activities of large foreign companies that operate in Africa mostly in sectors such as oil, precious metals and minerals, and ores. This is equal to three-quarters of FDI that the continent receives annually. If they are added to recorded profit remittances by TNCs, then the region would go into the red in net transfers on FDI.

## V.2. Trade and income transfers by TNCs

A broader measure of the impact of FDI on balance-of-payments incorporates exports and imports of foreign-owned firms in addition to income transfers. The initial inflow of FDI for greenfield investment often entails imports of capital goods required to install production capacity but these are financed by the inflow of FDI. In fact, since part of the goods and

<sup>10</sup> A factor contributing to tax avoidance is double taxation agreements promoted by countries such as Switzerland which often commit EDEs to low withholding tax rates in order to create more favourable conditions for their investors and in exchange for greater help in information for tracking tax evaders; see Bononami and Meyer-Nandi (2013).

services needed to install production capacity would be procured locally, the overall payment impact would be positive.

The subsequent impact of foreign firms on the trade balance depends not only on their imports and exports, but also their effect on the imports and exports in the economy as a whole through supply and demand linkages and macroeconomic channels. A full account of the impact of FDI on imports would require identification of not only direct imports by the firms concerned but also the indirect imports embodied in the goods and services locally procured. Foreign firms may also generate import substitution effects or can facilitate or impede exports by local firms. However, most empirical studies on the balance-of-payments impact of FDI do not explicitly account for such indirect effects and spillovers.

The debate on the balance-of-payments impact of FDI has often focussed on the distinction between traded and non-traded sectors. FDI in non-traded sectors clearly leads to a net outflow of foreign exchange because it does not generate export earnings (or import substitution) but entails imports and profit remittances. Services are traditionally considered as a non-tradeable sector. However, the tradability of services has been increasing rapidly. In the past three decades international trade in commercial services has grown faster than trade in goods. They now account for a sizeable proportion of export earnings of some EDEs such as India where FDI is found to have played a significant role in the expansion of services exports (Saleena 2013).

However, despite their increased tradability, an important part of services are still non-traded. This implies that, *ceteris paribus*, a shift in the composition of FDI from primary and manufacturing sectors towards services could be expected to exacerbate its overall trade-balance impact. Indeed, such a shift had already started in the 1990s but accelerated in the new millennium. In the early 1990s services had accounted for some 45 per cent of total FDI inflows to EDEs, and this proportion averaged at almost 60 per cent during 2010-12 (Chart 6). During the same period the share of manufacturing in total FDI inflows to EDEs fell from 36 per cent to 27 per cent while the primary sector enjoyed a small gain thanks to the commodity boom that started in the early years of the new millennium. If China is excluded, the increase in the share of services and the decline in manufacturing in FDI inflows to EDEs are much more pronounced.

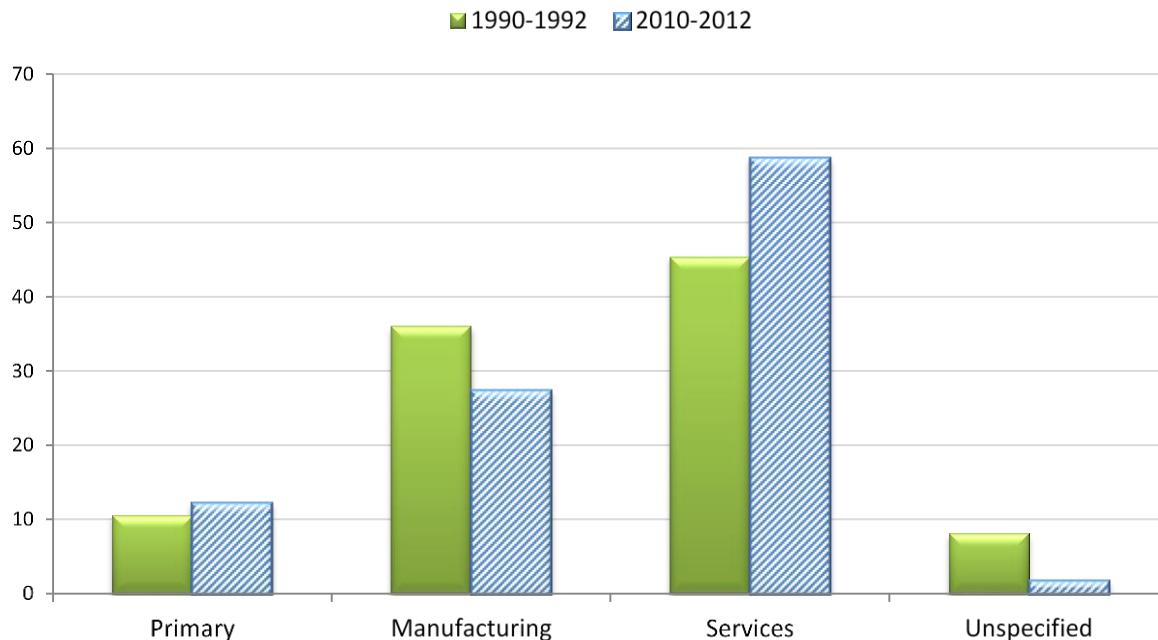
On the other hand, the decline in the share of manufacturing in total FDI has been associated with a fundamental change in the nature of foreign investment in that sector. While earlier FDI flows into manufacturing were mainly motivated by attempts to overcome barriers to trade and involved establishing similar plants across countries, recently this horizontal production structure has been increasingly replaced by a vertical structure designed “to slice up the value chain” through international production networks. This shift in the composition of FDI in manufacturing can be expected to improve its contribution to the balance of payments.

In discussing the impact of FDI on the current account, it would be more appropriate to distinguish between inward-oriented and outward-oriented FDI rather than traded and non-traded sectors. This applies to all sectors, primary, manufacturing and services, though in different degrees. Inward-oriented foreign firms sell mainly in the domestic market while the principal outlets of outward-oriented TNCs are abroad. Foreign manufacturing firms established for tariff-jumping and market-seeking purposes fall into the former category and

often entail more imports than exports. This is also true for most, though not all, foreign investment in services.

**Chart 6: FDI inflows to EDEs by sector and industry: 1990-1992 and 2010-2012**  
(*Per cent of total FDI inflows*)

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*Source:* UNCTAD WIR (2014).

By contrast, foreign firms in natural resources such as those in most parts of Africa are generally outward oriented. Domestic sales constitute a very small proportion of their total production and they generate more exports than imports. Thus, their impact on the balance-of-payments tends to be positive. Firms linked to international production networks established and controlled by TNCs for supplying consumer manufactures to global markets are also outward oriented, but their domestic sales account for a greater proportion of total production than is typically the case for foreign firms active in primary sectors. Outward-oriented firms established in Export Processing Zones (EPZ) also sell a very large proportion of their production abroad.

Production by foreign firms is generally more import intensive than local firms. There is also evidence that wholly foreign-owned firms are more import intensive than joint venture firms. On the other hand, in countries closely integrated into the international production networks such as China and South East Asian EDEs and Mexico, the average import intensity or foreign value-added content of exports is higher than those which are not so closely connected to such networks, such as Brazil and most other Latin American countries, South Africa, India, Russia and Turkey (Koopman *et al.* 2010; Koopman *et al.* 2012; Akyüz 2011b). In the former cases, an important part of the domestic value-added is absorbed by profits of TNCs, which often enjoy tax concessions. This proportion is

estimated to have been around three-quarters of value-added in the Chinese export sector (Akyüz 2011a).

The impact of fully inward-oriented foreign firms to the current account is negative while their contribution to GDP and GNI varies inversely with their imports and profits. Even when exports by these firms meet their import bill, the impact on the current account would be negative because of profit remittances. To stop such firms from running current account deficits, it would be necessary to raise their exports without commensurate increases in the import content of production.

The contribution of outward-oriented foreign firms to GDP and GNI tend to be lower than that of inward-oriented firms because of their high import intensity. But their impact on the current account could be superior because of strong export orientation. This means that there may be no one-to-one correspondence between the export performance of TNCs and their contribution to domestic income. Indeed, some countries closely linked to international production networks in manufacturing are known to have increased their shares in world manufactured exports significantly without commensurate increases in their shares in world value-added in manufacturing. This happened in Mexico in the 1990s. After NAFTA, Mexico's share in world manufactured exports increased significantly while its share in world manufacturing value-added dropped. This happened because as high-export, low-value-added firms in maquiladoras expanded, the traditional industries with high value-added but low exports withered (UNCTAD TDR 2002 and TDR 2003).

Often, outward-oriented foreign firms established in EPZ have little supply and demand linkages with the economy except through employment. They promise no significant dynamic benefits and their contribution to the current account is mainly confined to wage payments since such arrangements often include tax and tariff concessions. Their impact is quite similar to that of remittances from migrant workers abroad. However, since public investment would be required to establish a zone, the foreign exchange surplus generated by these firms may not justify the costs incurred.

The main policy challenge in EDEs closely connected to international production networks in manufactures in improving the contribution of foreign firms to the balance-of-payments, employment and domestic value-added is to reduce the import content of their production rather than to increase their export-orientation. This would mean import substitution; that is, moving up in the value chain and replacing imported high-value parts and components with domestic production.

The impact of FDI on the current account naturally depends on the type of investment as well as the policies affecting import content and export-orientation of foreign firms. That FDI would have a negative impact in countries where it is concentrated in areas with little or no exports is incontrovertible. However, the discussions above suggest that this may also be the case even in countries with strong presence of export-oriented foreign firms because of their high import intensity and profit remittances.

This appears to be the case in several South East Asian EDEs closely connected to international production networks in manufacturing. Jansen (1995) simulated a model for Thailand for 1987-1991 to assess, *inter alia*, the impact of FDI on the balance-of-payments (see also UNCTAD WIR 1997). It is found that while FDI had a strong role in the expansion of exports, it also led to a sharp increase in imports as well as royalty and licence fees and

profit remittances. About 90 per cent of all machinery and equipment used for foreign investment projects and 50 per cent of raw materials are estimated to have been imported. From mid-1980s until 1991-92, exports as a per cent of GDP rose from 29 per cent to 36 per cent while imports increased from 25 per cent to 40 per cent. All these widened the current account deficit more than the increase in FDI inflows and contributed to the build-up of external debt that culminated in the 1997 crisis.

A study on Malaysia also estimated that the impact of foreign firms on the current account, including the initial imports associated with FDI inflows, was negative in every year during 1980-1992 and FDI inflows could offset this in only four years (Eng 1998). According to another estimate, the FDI-related current account continued to be in the red also during 1993-96 (Woodward 2001). Putting all these together, it appears that throughout the entire period 1980-1996, the impact of FDI on the current account in Malaysia was negative in every year and new FDI inflows matched or exceeded these deficits in only five years.

There is also evidence from other countries with significant presence of outward-oriented foreign firms in services and manufacturing sectors. India is one of them. As noted, FDI has played an important role in the rapid expansion of its services exports. Still, the overall impact of FDI on the Indian current account appears to have been negative over 1997-2011 (Sarode 2012). Another estimate comes from Indonesia, one of the top recipients of FDI inflows among EDEs (Dhanani and Hasnain 2002). During 1990-96, FDI accounted for a quarter of manufacturing production in Indonesia. However, foreign firms imported 55 per cent of raw materials and intermediate goods; more than double that of domestic firms. Overall, FDI had a negative impact on the balance of payments and contributed to the persistent deficits in manufacturing due to its high propensity to import production inputs.

China's experience as a major recipient of export-oriented FDI reveals some interesting features and lessons for countries wanting to integrate closely into international production networks established and controlled by TNCs from AEs. It was estimated by UNCTAD (WIR 1997: Chapter II) that the trade balance of foreign affiliates in China was negative throughout 1994-1996. Adding payments of direct investment income, this meant even a larger deficit in the current account. However, these were more than covered by new inflows of FDI as China had emerged as the largest recipient of FDI in the developing world in the 1990s. The trade deficits of foreign firms were due to those in non-processing trade since export-oriented firms in processing trade generated growing surpluses as a result of declines in their import intensity. However, the import intensity of these firms was still higher than that of local firms in processing trade – 78 per cent compared to 66 per cent.

More recent research based on input-output data and accounting for indirect as well as direct import contents indicates that the average import intensity of Chinese exports has declined in the new millennium. In processing exports where foreign firms are dominant, China has been shifting from simple assembly of foreign parts and components towards operations with greater domestic inputs, thereby raising their domestic value-added content. According to an estimate, the share of foreign value-added in China's processing exports fell from 79 per cent in 1997 to 62.7 per cent in 2007 and in its total manufactured exports from 50 per cent to 40 per cent (Koopman *et al.* 2012).

This resulted in a significant improvement in the trade balance of foreign affiliates in China in the new millennium. Indeed, exports by foreign-funded firms, including wholly foreign-owned and joint venture firms, constantly exceeded imports after 2000 (Table 4).

Income payments on direct investment also rose rapidly, but the trade surplus generated by foreign firms was large enough to finance these until 2010. Since that year, the current account balance of foreign affiliates in China turned to be negative with income payments exceeding the trade surplus generated by these firms. This implies that, unless the import intensity of foreign affiliates is reduced significantly, China could face growing current account deficits on their operations as income payments on the stock of FDI mount.<sup>11</sup>

**Table 4: Foreign-funded Enterprises in China**

(Billions of US dollars)

	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Imports	117.3	387.5	472.5	559.8	619.4	545.4	738.4	864.7	871.5	874.6
2. Exports	119.4	444.2	563.8	695.4	790.5	672.1	862.2	995.2	1022.6	1043.7
3. Trade balance	2.2	56.7	91.3	135.6	171.1	126.7	123.8	130.6	151.1	169.1
4. FDI Income payments	20.2	47.6	49.5	61.9	72.6	105.9	159.6	204.5	171.8	206.4
5. Current account impact	-18.0	9.1	41.8	73.7	98.4	20.7	-35.8	-73.9	-20.7	-37.2
6. FDI inflows	38.4	111.2	133.3	169.4	186.8	167.1	273.0	331.6	295.6	347.8

*Source:* National Bureau of Statistics of China and IMF *Balance of Payments Statistics database*.

As in the 1990s, FDI inflows have been strong enough to meet the foreign exchange shortfalls generated by foreign affiliates in China in recent years. However, closing the gap with more and more FDI inflows would be very much like Ponzi financing whereby existing liabilities are met by incurring new liabilities. It is true that currently China does not need new FDI inflows to pay for the existing ones. Despite growing income payments on FDI stock, China has been running a current account surplus thanks to a strong export performance of its local firms. However, although it has a positive net international asset position (Akyüz 2014), it has been in the red in investment income – since 2000, income paid by China on all foreign liabilities, including debt and equities, has exceeded the income received on all foreign assets held in every year except 2007-08. Its outward FDI stock has reached almost two-thirds of its inward FDI stock, but income generated by FDI assets has been less than 15 per cent of income paid on FDI liabilities.

It is not clear if China can keep running surplus on its current account. Its surplus has already declined from a peak of 10 per cent of GDP in 2007 to less than 2 per cent in 2013-14. There is a wide agreement that China needs to increase the share of private consumption in GDP in order to sustain an acceptable pace of growth. If consumption starts rising faster than other components of aggregate demand, its trade surplus can shrink rapidly and may even fall below the net investment income payments abroad, thereby leading to a deficit on the current account. Thus, a viable strategy for China would be to continue to reduce the import intensity of its exports, primarily by foreign affiliates.

Recent evidence suggests that import substitution in China's export industries has been continuing with full force since the crisis and this is a main factor in the slowdown in global trade. For the first time in over four decades international trade grew more slowly

<sup>11</sup> An earlier study on the dynamic effect of FDI on the balance-of-payments in China concluded that as more companies come in, China's current account could turn from a surplus to a deficit; see, Yao and Fan (2004).

than world income during 2012-13. It is argued that this cannot be explained by cyclical factors alone such as the Eurozone crisis. The link between trade and income growth is seen to have been undergoing a structural change since the crisis with income growth generating slower expansion of trade than in the past. According to this analysis, the changing relationship between world trade and income “is driven primarily by changes in supply-chain trade in the two largest trading economies, the United States and China … [and] is reflected in a fall in the share of Chinese imports of parts and components in total exports, which decreased from its peak of 60 percent in the mid-1990s to the current share of about 35 percent” (Constantinescu *et al.* 2014: 40-41). Thus, in China, a larger proportion of effective demand, both domestic and foreign, is now met by domestic production rather than imports as many activities that previously involved cross-border movement of goods are now taking place within national borders.

There can be little doubt that FDI should not be judged on the basis of its balance of payments impact alone. It may yield other benefits even when it has a negative contribution to the current account, such as easier access to markets abroad and positive spillovers to the rest of the economy. However, these benefits should be carefully weighed against the costs inflicted by the deficits of foreign firms. These costs can be quite onerous in a forex-constrained economy. Deficits run by foreign firms can reduce the volume of imports of capital and intermediate goods needed to operate and add to existing productive capacity, thereby depressing economic activity and lowering aggregate employment even if these firms themselves employ a relatively large number of local workers. To avoid these outcomes, the country would need to borrow internationally in order to meet the current account deficits generated by foreign firms.

If the impact of FDI on the current account is negative and foreign firms bring no significant spillovers and externalities, it might be preferable to borrow the money and make the investment domestically rather than rely on FDI. This is because the rate of return on FDI is much higher than borrowing costs, estimated at close to 20 per cent for a sample of EDEs over 1995-98 (Lehmann 2002). It is true that income payments on FDI depend on the profitability of enterprises and, unlike debt, no payment would be involved unless profits are generated. But this also means that the host country would be writing a “blank check” (Woodward 2001; 144) which could eventually entail significant transfer of resources. Thus, it could be cheaper to make the same investment with borrowed money.

## VI. SPILLOVERS, GROWTH AND STRUCTURAL CHANGE

TNCs from more advanced economies enjoy certain capabilities and own firm-specific tangible and intangible assets that distinguish them from their competitors. They take these assets to EDEs in which they invest, but they would be reluctant to pass their competencies onto local enterprises since that would reduce the rent they can earn. Furthermore, the competitive advantage they have can also damage local industry. Deliberate and carefully designed policies are needed both to prevent potential adverse effects of TNCs on the host economy and to promote positive spillovers. For this, it is important to correctly identify the capabilities of foreign firms, the channels through which they could stimulate growth and structural change, and the policies needed to deploy them.

There is a vast literature on the capabilities and competencies of TNCs from more advanced countries and the nature, channels and effects of spillovers to the local economy in host countries (Kumar 2002; Malik *et al.* 2012; Forte and Moura 2013; Danakol *et al.* 2014). In this context, FDI is seen not so much as a flow of capital but as a flow of advanced technology and management skills – the two key determinants of their superior productivity. In addition, these firms also enjoy better access to global markets because of their close linkages. Exporting and international procurement are easier and less costly to them than to local firms. They often have the advantage of a brand image, and this helps them not only in marketing goods and services but also in attracting the best talents. They also enjoy easier access to international financial markets and better credit ratings and this gives them a significant cost advantage.

The main channels through which technological spillovers from TNCs to the economy of host countries occur include competition, imitation, demonstration and labour turnover. However, the impact is not always benign. The high productivity and competition they bring could help improve the efficiency of local firms, but these can also block entry of these firms into high-value production lines or drive them out of business. They can prevent rather than promote infant-industry learning unless local firms are supported and protected by deliberate policies. Local firms can learn and imitate more easily when foreign firms establish forward and backward linkages with them rather than relying on linkages abroad. Domestic linkages are also essential for the integration of local firms in the global market. Foreign affiliates can have an important impact on industrial structure if they invest in relatively technology-intensive industries and relocate some of their R&D activities in host countries, but this may not be the most profitable option for them. Again, they can help improve the skill profile and the level of technical knowledge in the host country by employing and training local workers, but not so much when they focus on labour-intensive sectors or import labour along with capital.

For all these reasons there can be no generalization regarding the impact of FDI on capital formation, technological progress, economic growth and structural change. Indeed there is no conclusive evidence to support the myth that FDI makes a major contribution to growth. This is emphatically put by Caves (1996: 237): “the relationship between an LDC’s stock of foreign investment and its subsequent economic growth is a matter on which we totally lack trustworthy conclusions.” What is established by most studies is that the impact of FDI depends on a host of other variables which are endogenous to the growth process. Positive spillovers from foreign firms can become significant only when there is already in

place an appropriate level of local capabilities. Even then, policy in host countries plays a central role in generating the conditions needed to secure positive spillovers.

There is considerable diversity in the extent to which EDEs have been relying on FDI for industrialization and development. Successful examples are found not necessarily among EDEs that attracted more FDI, but among those which used it in the context of national industrial policy designed to shape the evolution of specific industries through intervention so as to accelerate industrialization and growth. In fact, extensive presence of foreign firms could well be a sign of weakness of indigenous capabilities.

Both cross-country and case studies show that in several instances performance requirements imposed on FDI made a positive contribution to various development objectives without having a major adverse impact on the FDI received.<sup>12</sup> East Asian EDEs have generally been more successful in attracting and using FDI for industrialization than countries at similar levels of development elsewhere. However, there is significant diversity among them in the extent to which they have relied on FDI as well as in the policies pursued (UNCTAD TDR 1994 and 1996).

Among the first-tier newly industrializing economies (NIEs) Korea and Taiwan relied on FDI much less than Singapore and Hong Kong as well as the second-tier NIEs, notably China, Malaysia and Thailand. As in Japan, they focused on promoting indigenous enterprises and local technological capabilities, using FDI only in targeted industries alongside other forms of technology transfer such as reverse engineering, import of capital goods and technology licencing. They also used original equipment manufacturer (OEM) to encourage foreign firms to supply technological information and integrate local firms into international markets. Strong support was provided to R&D to help adapt and improve imported technology.

FDI regimes in Korea and Taiwan were restrictive and selective, and domestic policies were highly interventionist, particularly during the catching-up period. Licencing agreements were tightly controlled and imported technologies were closely screened to promote domestic learning. Local firms were nurtured to compete with TNCs and reduce dependence on them, particularly in Korea. Foreign ownership was restricted in certain sectors and joint ventures rather than wholly foreign owned enterprises were promoted. Local content agreements were extensively used not only for balance-of-payments reasons, but also to promote linkages with domestic suppliers and hence facilitate diffusion of technology and management skills. Managerial and technical assistance and training of engineers and technicians were part of the contracts with foreign companies, notably from Japan.

Although both Hong Kong and Singapore relied heavily on FDI, there were important differences in the policies pursued and hence the contribution of FDI to industrialization. While Hong Kong followed a laissez-faire policy towards FDI, Singapore targeted specific industries for promotion, using incentives and restrictions. In Hong Kong FDI helped to establish a low-skill industrial base, but brought little upgrading. Its lack of industrial depth and massive deindustrialization thus stand in sharp contrast with the rapid upgrading and industrial success of Singapore.

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<sup>12</sup> On theoretical issues involved and empirical evidence, see a number of essays in Kozul-Wright and Rowthorn (1998), Kumar (2005) and Rasiah (2005).

Among the second tier-NIEs, Malaysia and Thailand have followed a liberal approach towards FDI, allowing fully-owned foreign subsidiaries. However, after an initial success in establishing assembly industries, they have not been able to develop a diversified manufacturing base and reduce their dependence on imported capital and intermediate goods. By contrast China's FDI regime has been more restrictive and policies highly interventionist. It started like Malaysia and Thailand, combining low skilled assembly activities with high-technology imported parts, but moved more vigorously in upgrading and reducing the foreign value-added in its production and exports, as noted above.<sup>13</sup> However, while it has moved faster than all late-industrializers over the past three decades, including the first-tier NIEs, it still has a long way to go to catch up with the productivity levels and industrial sophistication of indigenous firms not only in Japan but also in Korea (Zhu 2012).

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<sup>13</sup> Exports of South-East Asian NIEs, including Malaysia, Thailand and Vietnam have higher import contents than exports of China; see Akyüz (2011a).

## VII. MULTILATERAL AND BILATERAL CONSTRAINTS OVER INVESTMENT POLICY

The experience strongly suggests that policy interventions would be necessary to contain adverse effects of FDI on stability, balance of payments, capital accumulation and industrial development and to activate its potential benefits. However, policy options in EDEs have been increasingly circumscribed in the past three decades as international capital and TNCs have gained more and more space to manoeuvre. There are two main sources of constraints over national policy in this area; multilateral rules and obligations in the WTO regarding investment policies, and commitments undertaken in investment and trade agreements signed with home countries of investors in EDEs. Although there is considerable diversity in the obligations contained in various BITs, the constraints they entail are becoming increasingly tighter than those imposed by the WTO regime.

There are two main sources of WTO disciplines on investment-related policies; the Agreement on TRIMs and specific commitments made in the context of GATS negotiations for commercial presence of foreign enterprises (the so-called mode 3) in the services sectors. In addition to these a number of other agreements provide disciplines, directly or indirectly, on investment-related policies such as the prohibition of investment subsidies linked to export performance in the Agreement on Subsidies and Countervailing Measures.

The TRIMs agreement does not refer to foreign investment as such but to investment generally.<sup>14</sup> It effectively prohibits attaching conditions to investment in violation of the national treatment principle or quantitative restrictions in the context of investment measures. The most important provisions relate to prohibition of domestic content requirements whereby an investor is compelled or provided an incentive to use domestically produced rather than imported products, and of foreign trade or foreign exchange balancing requirements linking imports by an investor to its export earnings or to foreign exchange inflows attributable to investment. By contrast, in TRIMs or the WTO more broadly, there are no disciplines restricting beggar-my-neighbour investment incentives by recipient countries that are just as trade distorting. Such incentives provide effective subsidy to foreign investors and can influence investment and trade flows as much as domestic content requirements or export subsidies, particularly since a growing proportion of world trade is taking place among firms linked through international production networks controlled by TNCs (Kumar 2002).

The obligations under TRIMs may not affect very much the countries rich in natural resources, notably minerals, in their earlier stages of development. FDI in mineral resources is generally capital intensive and countries at such stages depend almost fully on foreign technology and know-how in extractive industries and lack capital good industries. Linkages with domestic industries are usually weak and output is almost fully exported. Domestic content of production by foreign companies is mainly limited to labour and some intermediate inputs. The main challenge is how to promote local processing to increase domestic value-added. However, over time, restrictions over domestic content requirements can reinforce the “resource curse syndrome” as the country wants to nourish resource-based

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<sup>14</sup> This is provided by a subsequent interpretation by a panel on a TRIMs dispute; for a detailed discussion, see Das (1999: chap.3.6) and Bora (2002).

industries, to transfer technology to local firms and establish backward and forward linkages with them.

Restrictions over domestic content requirements are particularly important for investment in manufacturing in countries at intermediate stages of industrialization, notably in automotive and electronics industries – the two key sectors where they were successfully applied in East Asia. As noted, most industries of EDEs linked to international production networks have high import contents in technology-intensive parts and components while their domestic value-added mainly consists of wages paid to local workers. Raising domestic content would not only improve the balance-of-payments but also constitute an important step in industrial upgrading. Restrictions over domestic content requirements would thus limit transfer of technology and import-substitution in industries linked to international production networks.

However, TRIMs provisions leave certain flexibilities that could allow EDEs to make room to move in order to increase benefits from FDI. First, the domestic content of industrial production by TNCs is not independent of the tariff regime. Other things being equal, low tariffs and high duty drawbacks encourage high import content. Thus, it should be possible to use tariffs as a substitute for quantity restrictions over imports by TNCs when they are unbound in the WTO or bound at sufficiently high levels. Similarly, in resource rich countries, export taxes can be used to discourage exports of unprocessed minerals and agricultural commodities as long as they continue to remain unrestricted by the WTO regime.

Second, as long as there are no commitments for unrestricted market access to foreign investors, the constraints imposed by the TRIMs agreement could be overcome by tying the entry of foreign investors to the production of particular goods. For instance a foreign enterprise may be issued a licence for an automotive assembly plant only if it simultaneously establishes a plant to produce engines, gearboxes or electronic components used in cars. Similarly, licences for a computer assembly plant can be tied to the establishment of a plant for producing integrated circuits and chips. Such measures would raise domestic value-added and net export earnings of TNCs and would not contravene the provisions of the TRIMs agreement.

Third, export performance requirements can be used without linking them to imports by investors as part of entry conditions for foreign enterprises. This would not contravene the TRIMs agreement since it would not be restricting trade (Bora 2002: 177). Finally, the TRIMs regime does not restrict governments in demanding joint ventures with local enterprises or local ownership of a certain proportion of the equity of foreign enterprises. In reality, many of these conditions appear to be used widely by industrial countries in one form or another (Weiss 2005).

Since the TRIMs agreement applies only to trade in goods, local procurement of services such as banking, insurance and transport can also be set as part of entry conditions of foreign firms in order to help develop national capabilities in services sectors. However, this would be possible as long as EDEs continue to have discretion in regulating access of TNCs to services sectors. The existing GATS regime provides considerable flexibility in this respect, including for performance requirements. However, the kind of changes in the modalities of GATS sought by AEs, including the prohibition of pre-establishment conditions

and the application of national treatment, could shrink policy space in EDEs a lot more than the TRIMs agreement.<sup>15</sup>

The constraints exerted by most BITs signed in recent years on policy options in host countries go well beyond the TRIMs agreement because of wide ranging provisions in favour of investors. These include broad definitions of investment and investor, free transfer of capital, rights to establishment, the national treatment and the most-favoured-nation (MFN) clauses, fair and equitable treatment, protection from direct and indirect expropriation and prohibition of performance requirements (Bernaconi-Osterwalder *et al.* 2012). Furthermore, the reach of BITs has extended thanks to the use of the so-called SPEs.<sup>16</sup> Many BITs also provide unrestricted arbitration, freeing foreign investors from the obligation of having to exhaust local legal remedies in disputes with host countries before seeking international arbitration. This, together with lack of clarity in treaty provisions, has resulted in the emergence of arbitral tribunals as lawmakers in international investment. These tend to provide expansive interpretations of investment provisions, thereby constraining policy further and inflicting costs on host countries (Bernaconi-Osterwalder *et al.* 2012; Eberhardt and Olivet 2012; UNCTAD TDR 2014).

While in TRIMs investment is a production-based concept, BITs generally incorporate an asset-based concept of investment whether the assets owned by the investor are used for the production of goods and services, or simply held with the prospect of income and/or capital gain. This is largely because BITs are fashioned by corporate perspectives even though they are signed among governments. Typically, agreements are prepared by the home countries of TNCs and offered to EDEs for signature. They include a broad range of tangible and intangible assets such as fixed-income claims, portfolio equities, financial derivatives, intellectual property rights and business concessions as well as FDI as officially defined by the OECD and the IMF. This implies that all kinds of assets owned by foreigners could claim the same protection and guarantees independent of their nature and contribution to stability and growth in host countries.

It also opens the door to mission creep. Investment agreements may be granted jurisdictions by tribunals over a variety of areas that has nothing to do with FDI proper, further circumscribing the policy options of host countries. Indeed, the expansive scope of investment protection in NAFTA has already given rise to claims that patents are a form of investment and hence should be protected as any other capital asset, thereby threatening the flexibilities left in the TRIPs Agreement and access to medicines (Correa 2013). Similarly, there have been claims by Argentinian bond holders that such holdings should be protected as any other investment under the Italy-Argentina BIT, thereby intervening with the restructuring of sovereign debt (Gallagher 2012).

The combination of a broad, asset-based concept of investment and provisions for free transfer of capital seriously exposes host EDEs to financial instability by precluding controls over destabilizing capital flows. This is also recognized by the IMF. In its Institutional View

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<sup>15</sup> Cho and Dubash (2005) discuss the implication of adopting national treatment in GATs in relation to the electricity sector while Rasiah (2005) provides an illustrative account of it for policy space in Malaysia.

<sup>16</sup> For example if country A has no BIT with country B and a TNC from A wants to invest in country B, it can create an affiliate in country C with a BIT with country B and makes the investment through that affiliate in order to benefit from the BIT between B and C. This creates “transit FDI” and leads to double-counting in reported FDI figures – see UNCTAD WIR (2014: Box I.1).

on the Liberalization and Management of Capital Flows, the IMF (2012) notes that “numerous bilateral and regional trade agreements and investment treaties … include provisions that give rise to obligations on capital flows” (para 8) and “do not take into account macroeconomic and financial stability” (para 65) and “do not allow for the introduction of restrictions on capital outflows in the event of a balance of payments crisis and also effectively limit the ability of signatories to impose controls on inflows” (Note 1, Annex III). The Fund points out that these provisions may conflict with its recommendation on the use of capital controls and asks its Institutional View to be taken into account in drafting such agreements.

Although the IMF’s Institutional View focuses mainly on regulating capital inflows to prevent build-up of financial fragility, prohibitions in BITs regarding restrictions over outflows can also become a major handicap in crisis management. It is now widely agreed that countries facing an external financial crisis due to an interruption of their access to international capital markets, a sudden stop of capital inflows and rapid depletion of reserves could need temporary debt standstills and exchange controls in order to prevent a financial meltdown (Akyüz 2014). However, such measures could be illegal under “free transfer of capital” provisions of BITs

Where rights of establishment are granted, the flexibilities in the TRIMs regarding entry requirements noted above would simply disappear. The national treatment clause in BITs requires host countries to treat foreign investors no less favourably than its own national investors and hence prevents them from protecting and supporting infant industries against mature TNCs and nourishing domestic firms to compete with foreign affiliates. It brings greater restrictions than national treatment in TRIMs because it would apply not to goods traded by investors but to the investor and the investment.

Further, provisions on expropriation and fair and equitable treatment give considerable leverage to foreign affiliates in challenging changes in tax and regulatory standards and demanding compensation. Especially the concept of indirect expropriation has led states to worry about their ability to regulate. The fair and equitable treatment obligation has also been interpreted expansively by some tribunals to include the right of investors to a stable and predictable business environment.

The large majority of outstanding BITs do not make any reference to performance requirements of the kind discussed above, but a growing number of them signed in recent years incorporate explicit prohibitions (Nikièma 2014). Some BITs go beyond TRIMs and bring additional prohibitions for performance requirements both at pre- and post-establishment phases. Others simply refer to TRIMs without additional restrictions. Still, this narrows the ability of governments to move within the WTO regime because it allows investors to challenge the TRIMs-compatibility of host country actions outside the WTO system. This multiplies the risk of disputes that host countries can face since corporations are much more inclined to resort to investor-state arbitration than the states do in the WTO system. The MFN clause could entail even greater loss of policy autonomy in all these areas, including performance requirements, by allowing foreign investors to invoke more favourable rights and protection granted to foreign investors in agreements with third-party countries.<sup>17</sup>

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<sup>17</sup> For a more detailed account of various provisions of BITs, their interpretation by tribunals and impact on policy space, see Bernasconi-Osterwalder *et al.* (2012).

While investment agreements entail a considerable loss of policy autonomy, they do not appear to be serving the intended purpose and accelerating the kind of FDI inflows sought by policy makers in host countries. Evidence suggests that BITs are neither necessary nor sufficient to bring significant amounts of FDI. Most EDEs are now wide open to TNCs from AEs through unilateral liberalization or BITs or Free Trade Agreements (FTAs), but only a few are getting FDI with significant developmental benefits and most of these countries have no BITs with major AEs. Econometric studies on the impact of BITs on FDI flows are highly ambivalent. While a few studies contend that BITs affect FDI flows, they do not examine whether BITs have led to the kind of FDI inflows that add to industrial dynamism in host countries. The majority of empirical studies find no link between the two (UNCTAD 2009b: Annex and UNCTAD TDR 2014: Annex to Chapter VI). Similarly, survey data show that the providers of political risk or in house counsel in large US corporations on investment decisions do not pay much attention to BITs (Yackee 2010).

## VIII. CONCLUSIONS

Unlike maintained by the dominant corporate ideology, FDI is not a recipe for rapid and sustained growth and industrialization in EDEs. A hands-off approach to FDI, as to any other form of capital, can lead to more harm than good. FDI policy needs to be embedded in the overall industrial strategy in order to ensure that it contributes positively to economic dynamism of EDEs. The discussions above suggest several policy lessons:

- Encourage greenfield investment but be selective in terms of sectors and technology;
- Encourage joint ventures rather than wholly foreign-owned affiliates in order to accelerate learning and limit foreign control;
- Allow M&A only if there are significant benefits in terms of managerial skills and follow-up investment;
- Do not use FDI as a way of meeting balance-of-payments shortfalls. The long-term impact of FDI on external payments is often negative even in EDEs attracting export-oriented firms;
- Debt financing may be preferable to equity financing when there are no significant positive spillovers from FDI;
- FDI contains speculative components and generates destabilizing impulses which need to be controlled and managed as any other form of international capital flows;
- No incentives should be provided to FDI without securing reciprocity in benefits for industrialization and development;
- Performance requirements may be needed to secure positive spillovers including employment and training of local labour, local procurement, domestic content, export targets and links with local firms;
- Domestic firms should be nurtured to compete with TNCs;
- Linking to international production networks organized by TNCS is not a recipe for industrialization. It could trap the economy in the lower ends of the value-chain.

Policy space in all these areas might be somewhat constrained by the WTO agreement on TRIMs, but it is still possible for EDEs to encourage positive spillovers without violating the WTO commitments. However, many of the more serious constraints are in practice self-inflicted through investment and free trade agreements. There are strong reasons for EDEs to avoid negotiating the kind of BITs promoted by AEs. They need to turn attention to improving their underlying economic fundamentals rather than pinning their hopes to BITs in attracting FDI. Where commitments undertaken in existing BITs seriously impair their ability to use FDI for industrialization and development, they can be renegotiated or terminated, as is being done by some EDEs, even if doing so may entail some immediate costs.

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