

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

*Yılmaz Akyüz\**

### **Abstract**

Foreign direct investment (FDI) is one of the most ambiguous and least understood concepts in international economics. Common debate over 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 the 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 ex-

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\* Chief Economist, South Center, Geneva. [south@southcentre.int](mailto:south@southcentre.int)  
Originally published as South Center Research Paper No. 63, October 2015. An earlier version was presented at the 8th Annual Forum of Developing Country Investment Negotiators, organized by the International Institute for Sustainable Development and the South Center, 5-7 November 2014, Montreux, Switzerland. I am grateful to the participants in the Forum and Nathalie Bernasconi, Humberto Campodonico, Lim Mah Hui, and Sanya Reid for their comments and suggestions, as well as to Xuan Zhang, for statistical assistance. The usual caveat applies.

port-oriented FDI. Finally, positive technological spillovers from FDI are not automatic but call for targeted policies of the kind that most investment agreements prohibit.

**Jel Codes:** F21, F23, F32, F63, O33

**Key Words:** Foreign direct investment, balance of payments, growth and development, technological change, transnational corporations

## **1. Introduction**

Foreign direct investment (FDI) is perhaps one of the most ambiguous and least understood concepts in international economics. Common debate over 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 the 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 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, i.e., 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 the 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 the 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.

All this does 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 that 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 activity 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 the erosion of policy autonomy 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 3,262 by 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-favored-nation (MFN) clauses, broad definitions of investment and investors, fair and equitable treatment, protection from expro-

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

priation, 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 having 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 the lack of clarity in treaty provisions, has resulted in the emergence of arbitral tribunals as lawmakers in international investment, and these tend to provide expansive interpretations of investment provisions in favor 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. Instead, most EDEs sign them on expectations that they will 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 gain their full potential benefits.

This paper revisits and reviews the key issues surrounding the place held by 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 the 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.

## **2. What is FDI?**

In common discussions, the term FDI is often meant to describe 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 am-

biguous than is widely 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>

The 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 over its management. The lasting interest and a significant degree of influence are said to be evidenced when the direct investor owns at least 10% of the voting power of the direct investment enterprise. Ownership below 10% is treated as portfolio equity investment.

Defined in this way, FDI comprises the initial equity transaction that meets the 10% 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% is totally arbitrary, and there is no compelling reason why investment in a 10% ownership stake should be less fickle than one in a 9.9% position. Both the OECD and the IMF recognize that, in practice, influence may be determined by several factors other 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 judgments.<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, 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 help in

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

identifying them. This is one of the drawbacks of empirical studies linking aggregate FDI to various economic performance indicators in host countries, such as GFCF, productivity, and growth.

Every financial transaction after the initial acquisition of equity by the investor, that is, internal capital flows within firms, are also considered 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 major swings in recorded FDI flows. “For instance, in 2012, high levels of repayment of loans to parent companies in Brazil by their 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.”

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 postwar period until the mid-1990s, the latter accounted for no less than one half of US outward direct investment (Lipse, 1999). It was even higher in more recent years because of growth of the US outward FDI stock. In 2008, retained earnings constituted 60% of outward FDI stock for non-bank affiliates of US non-bank corporations (Table 1). Globally, in 2011, they accounted for 30% 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% 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 unrepatriated profits).

### 3. FDI and Domestic Investment

As officially defined, FDI can take three main forms. The first is green-field 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 relates to existing company structures. Cross-border mergers arise when resident and non-resident companies agree to combine into a single operation.

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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.

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

	<b>1989</b>	<b>2008</b>
<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.

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% 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 the injection of fresh money, including loans from parent companies. When FDI is in the form of acquisition of existing public or private assets, it makes no direct contribution to domestic capital formation, although changes in ownership may give rise to



productivity gains, be followed by new investment by the direct investor, or 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 that 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 expenditures 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 canceled or may not start in the year when it is announced” (UNCTAD WIR 2014, p. 33, note 1). A comparison of reported FDI inflows with the sum total of M & A and greenfield projects shows considerable variations over the 2003-13 period. 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% of reported FDI figures. Given the global economic downturn after 2007, investment plans are unlikely to have been exceeded to the extent that they would account for the discrepancy. This strongly suggests that reported FDI data contain items that may not really qualify as direct investment.

The existing statistical measures cannot always identify the use made of unrepatriated 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 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, as opposed to constituting an independent source of financial income and speculative capital gains.

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<sup>5</sup> The fourth edition of the 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, pp. 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.

All these difficulties in interpreting the reported FDI data as investment in productive capacity are also recognized by UNCTAD (WIR 2014, p.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 companies. 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, the financial and technological strengths of these firms can simply crowd out domestic investors.

The empirical evidence for 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 displays 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 also has an 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 of this by Feldstein (1994), using data from the US for the 1970s and 1980s, concluded that outbound FDI reduced domestic investment about dollar for

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<sup>6</sup> Looking at Africa, Asia, and Latin America, Agosin and Machado (2005) find that the impact of FDI on domestic investment is at best neutral in all regions, with Latin America showing a 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.

dollar, whereas inbound FDI raised domestic investment by the same magnitude.

A more recent study of 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 complementary. 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 complementary 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 1990-2010 period 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 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 a rise in domestic investment in the new millennium, this was not the case in the 1990s.

**Table 2. Investment and FDI (Per cent of GDP)**

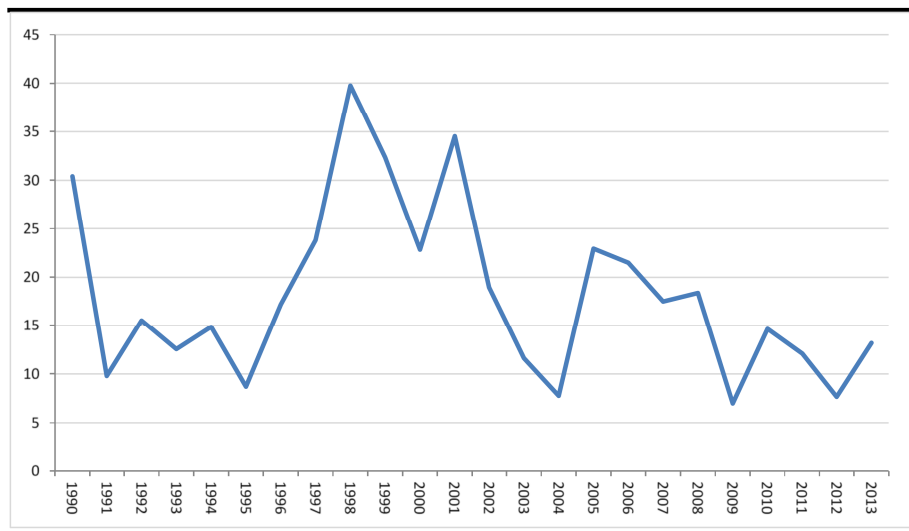
	Investment <sup>a</sup>			FDI Inflows		
	1981-1990	1991-2000	2001-2013	1981-1990	1991-2000	2001-2013
World	24.4	23.4	23.6	0.64	1.71	2.29
AEs	24.3	23.2	21.3	0.65	1.57	1.90
EDEs	24.4	24.4	28.4	0.59	2.19	3.12

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

a: Includes inventories

In the 1990s, the privatization of public assets played an important role in the boost 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 in 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 unfavorable 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).

**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

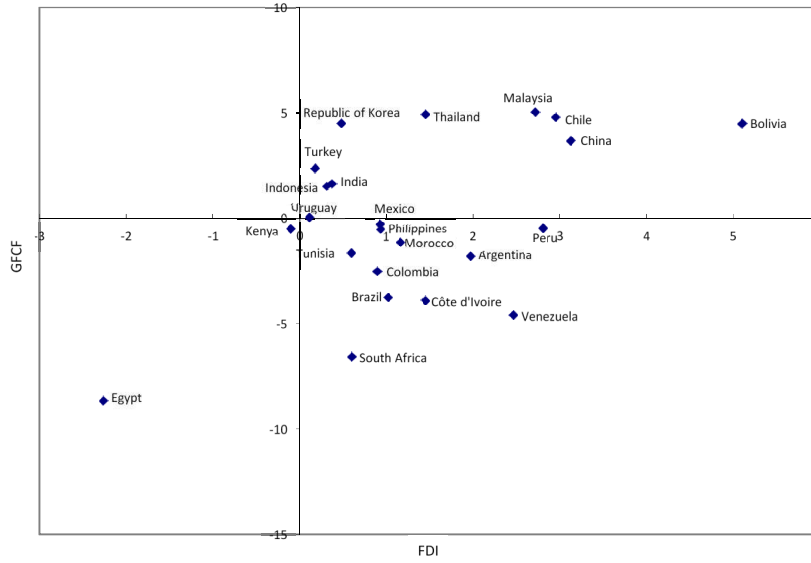
This suggests that the economic conditions that attract foreign enterprises may not always be conducive to faster capital formation and that the two sets of investment decisions may be driven by different considerations. Indeed, the generalized surge in FDI inflows to EDEs in the 1990s was not always accompanied by a concomitant increase in domestic capital formation. In Latin America, there was a widespread pattern of increased FDI combined 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 point (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 a substantial portion 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.

In the new millennium, in EDEs as a whole, both FDI inflows and investment as a percentage of GDP grew 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 fallout 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 that enjoyed booms in FDI inflows, GFCF fell or stagnated, including in Brazil, Korea, Turkey, and Thailand (Chart 2). In China, FDI inflows declined mainly because of contraction in its export markets, while GFCF jumped sharply because of the policy response of the government to ramifications from the crisis: a massive investment package. Among the East Asian countries severely hit by the 1997 crisis, only Indonesia saw a run-up in both FDI and GFCF in the 2000s compared to the 1990s, while Malaysia experienced a sharp contraction in both.

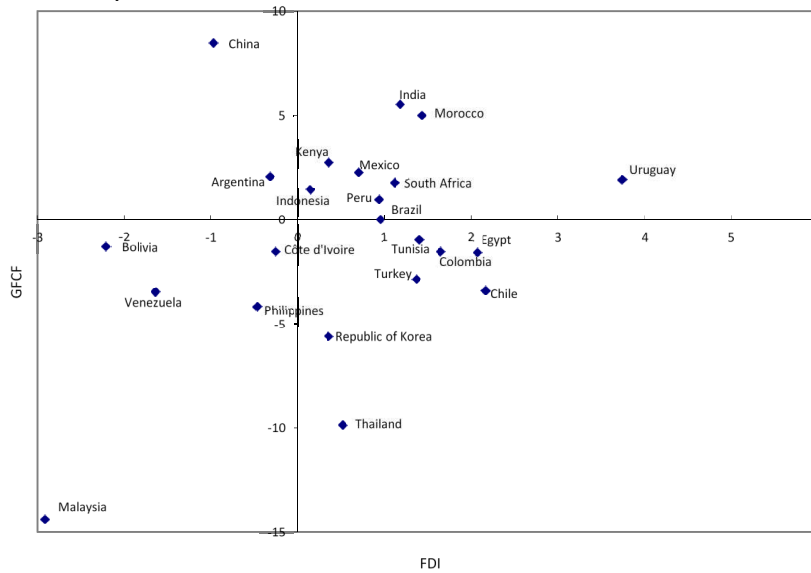
The examination of the movements of capital inflows to EDEs and domestic investment over the past two decades shows that FDI tends to move more closely with non-FDI flows than with domestic investment (Chart 3). From the mid-1990s until the end of the decade, there was an inverse correlation between FDI and domestic investment.

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

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

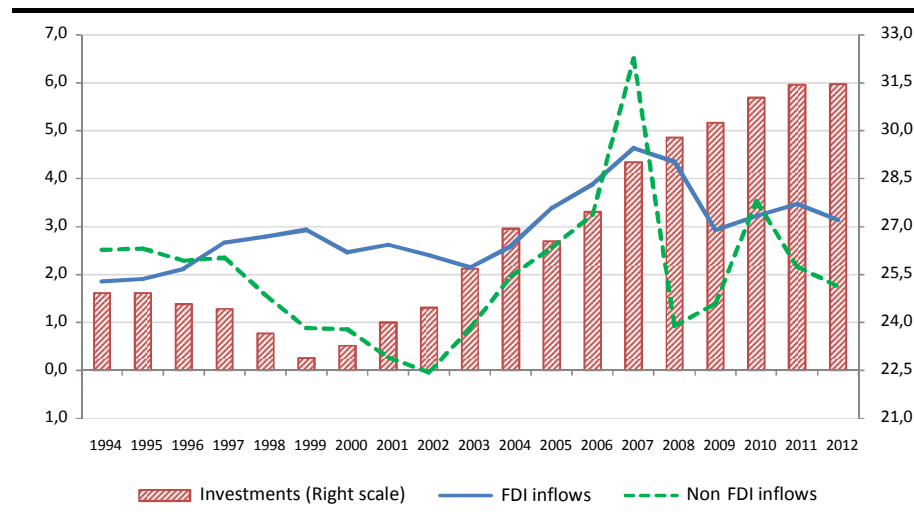


**2000-2012 compared to 1990-2000:**



Source: UNCTADstat.

**Chart 3. International Capital Inflow 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.

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, due, in part, to the fire-sale FDI in crisis-hit countries noted above. After 2002, FDI and non-FDI inflows followed a similar path, rising quickly until the Lehman turmoil, plunging during 2008-09, and recovering subsequently but remaining below their pre-crisis levels.

Generally, FDI seems to follow, not lead, domestic investment. Evidence from a study of a large sample of countries over the 1984-2004 period indeed shows that lagged domestic investment has a powerful influence over 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 a prime 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 forceful push for profits of TNCs, which constitute an important source of FDI. As noted by the BIS (1998, p. 28), “short-term movements in FDI flows are highly pro-cyclical,

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 that had experienced bursts in both types of inflows went on to live through falling or stagnant domestic investment rates and deindustrialization (Akyüz 2012; Naudé *et al.*, 2013).

#### **4. Impact on Stability**

It is widely held that FDI constitutes a stable source of finance for balance-of-payments shortfalls. According to 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 deterioration in global liquidity conditions and fading risk appetite is much lower than with 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, p. 3) Consequently, it is argued, they do not pose a serious threat to macroeconomic and financial stability in EDEs.

This account is misleading in that it ignores certain features of FDI and TNCs that can induce as much instability in the 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 accelerated the mobility of FDI, but also made it difficult to assess its stability.

First, recorded FDI statistics do not always enable the identifying of 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. Furthermore, 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 in-



vestor can borrow in order to export capital, and thereby generate rapid capital outflows (Claessen *et al.* 1993, p. 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 bump in FDI inflows could generate unsustainable currency appreciations in much the same way as booms in any other forms of capital inflows, unlike the endemic 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, p. 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 been central to the higher volatility and gyrations of property prices in the past two decades in several countries. Historical data on housing transactions in London show considerable 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 propelled 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 skyrocketed by almost 209% in the 12 months ending in October 2014, with the share of foreigners hitting a new high of 13% of the market (Taylor Wimpey, 2014). In Turkey, too, foreign buyers have been a main 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 the 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 countries for manufacturing production for global markets by TNCs can result in relocation

of production, particularly when host-country policies fail to lock TNCs into the economy with strong linkages to local firms and succeed in getting these companies 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). Elsewhere, certain TNCs in electronics left Mexican maquiladoras for China and a number of 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 hot money, encouraged by its entry to the EU and special incentives (Campa and Cull, 2013).

Finally, and perhaps more crucially, foreign banks established in EDEs can represent a looming source of financial instability. There is now a heavy presence of such banks in EDEs. Their share in banking in these economies doubled between 1995 and 2009 to reach 50% in the latter year, compared to 20% in OECD countries. A large majority of them are from AEs (Claessens and van Horen, 2012). These banks tend to skim the cream off of 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, opposite 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 EDEs' financial fragility and vulnerability to credit-market 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, p. 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 prelude to the crisis. Also, during the recent rush of capital inflows into 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 bringer of financial instability to 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 for capital outflows in support of their parent banks in the Eurozone core, leading to depletion of reserves and putting pressure on the currencies of host countries (Akyüz, 2014).

## **5. Impact on Balance-of-payments**

### **5.1. Net Transfers**

Most EDEs, particularly those with chronic current-account deficits and excessive dependence on foreign capital regard FDI more as a source of external financing 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 and is considered 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, discussed far and wide 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 by 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 goes up, 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 TNC involvement and thus a relatively large stock of foreign capital tend to suffer negative transfers. A developing economy with abundant labor and good infrastructure may start attracting hefty amounts of FDI for the production of labor-intensive manufactures for

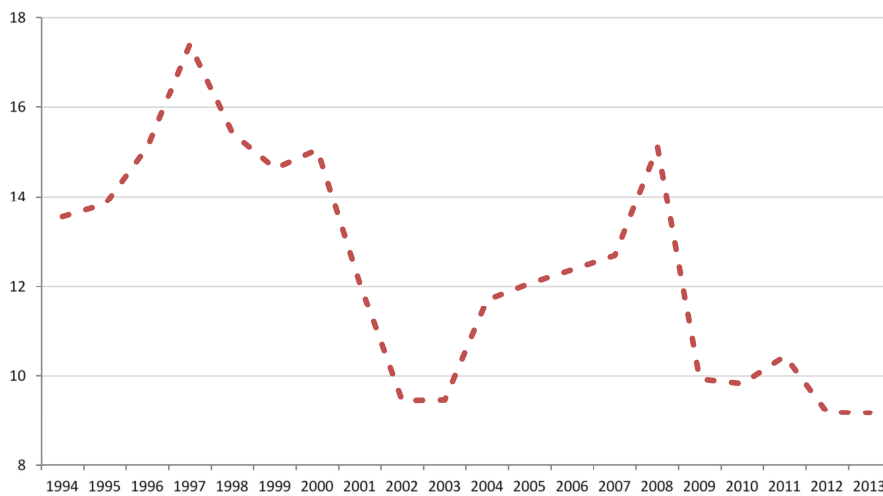
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<sup>7</sup> This holds whether or not profits are remitted, since retained earnings are recorded as FDI inflows.

global markets, but over time FDI inflows are likely to level off as the surplus labor is exhausted, and wages start climbing. 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 unleash a wave of FDI, but this 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 the initial influx of foreign funds. Indeed, 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% during the first half of the 1990s, before the recurrent crises in EDEs. It fell to 11.3% during 2002-07 and again to less than 10% during 2010-13.

**Chart 4. Inward FDI Investment in EDEs**  
Ratio of FDI Flows to FDI Stocks (*Per cent*)



**Source:** UNCTADstats.

For EDEs as a whole, on average, annual inflows of FDI exceed income payments on FDI stocks. However, there are considerable inter-country variations.

**Table 3. Net Transfers on FDI in Selected EDEs**  
Ratio of Cumulative Profit Payments to Cumulative FDI  
Inflows: 2000-2013

Ranking	Country	Ratio	Country	Ratio	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.

This is shown in Table 3 in terms of a comparison of cumulative income payments on the stock of FDI with 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 Southeast Asian countries that relied extensively on FDI from the early stages of their development. By contrast, the ratio of profit remittances to new inflows is low in countries that 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 sizable inflows of export-oriented FDI. On both a per-capita basis and relative to GDP, it had one of the biggest FDI stocks and flows in the developing world in the 1990s (UNCTAD TDR, 1997, Table 32). However, the momentum could not be maintained, and the country saw its FDI plummet in the new millennium (Chart 2) on the back of the emergence of low-cost venues further afield and as a consequence of its failure to upgrade rapidly; at the same time, income transfers on FDI stock kept

<sup>8</sup> According to Sumner *et al.* (2009, p. 3), in "sub-Saharan Africa, up to 90% 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.

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 content 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, such funds movements have been falling relative to the stock. This suggests that profit opportunities for foreign investors in labor-intensive sectors and processes for production for markets abroad are running out. To avoid a sharp drop in FDI inflows of the kind experienced by Malaysia, higher value-added sectors in China 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 comfortable trade surpluses in recent years to help them meet negative net transfers on FDI. But these surpluses have been falling rapidly following the end of the commodity boom, resulting in deterioration in the current account. In Malaysia and Nigeria, the current-account surplus collapsed, falling from double-digit figures during 2006-08 to 2-3% in 2015. In Libya and Algeria, the impressive surpluses of earlier years have already disappeared, and these countries are now running yawning current-account deficits. Most of the 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 due to the big income outflows on the stock of FDI.

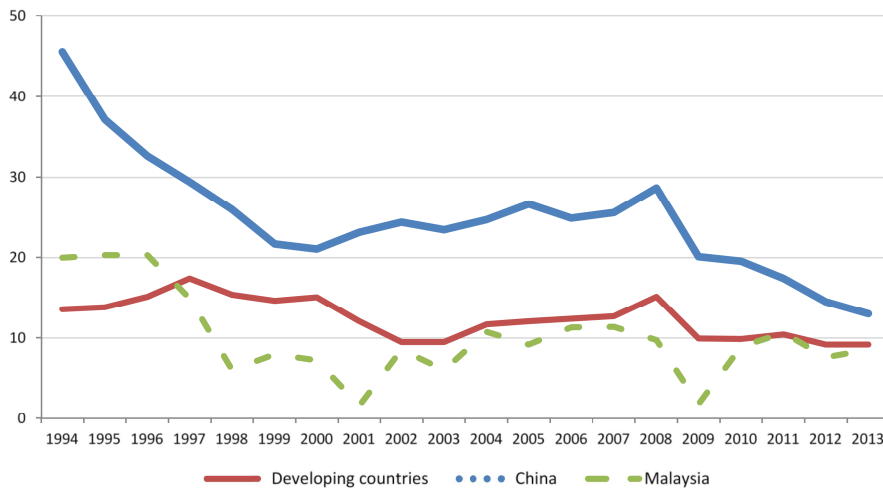
In addition to officially recorded income transfers, TNCs are known to be extensively involved in illicit financial outflows from EDEs through such practices as tax evasion, trade mis-pricing, and transfer pricing.<sup>10</sup> Various estimates show that these account for the bulk of illicit outflows from EDEs. According to a recent report by a panel chaired by the former president of South Africa, Thabo Mbeki, the continent has been losing \$50-60 billion per year in illicit financial outflows in recent years (UNECA, 2014).

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<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).

<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 favorable conditions for their investors) in exchange for greater help with tracking tax evaders; see Bonanomi and Meyer-Nandi (2013).

**Chart 5. FDI Inflows and Stocks in China and Malaysia**  
Ratio of FDI Flows to FDI Stock (*Per cent*)



**Source:** UNCTADstats.

About 60% of this originates 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 the FDI that the continent receives annually. If this is added to recorded profit remittances by TNCs, then the region would go into the red in net transfers on FDI.

## 5.2. Trade and income transfers by TNCs

A broader measure of the impact of FDI on the 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 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 corporations concerned but also the indirect imports embodied in the goods and services

locally procured. Foreign entities may also generate import-substitution effects or can facilitate or impede exports by their local counterparts. However, most empirical studies on the balance-of-payments impact of FDI do not explicitly account for such indirect effects and spillovers.

The debate over 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 powers imports and profit remittances. Services are traditionally considered a non-tradable sector. However, the tradability of services has been expanding rapidly. In the past three decades, international trade in commercial services has grown faster than the trade in goods. They now account for a sizable proportion of the export earnings of some EDEs, such as India, where FDI is found to have greatly contributed to the breakout of services exports there (Saleena, 2013).

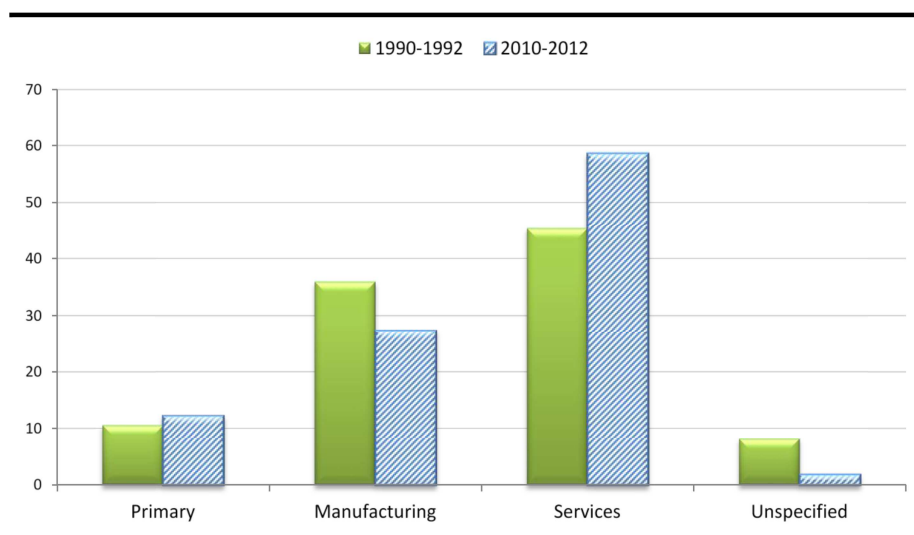
However, despite their increased tradability, much of the services sector is still non-traded. This implies that, *ceteris paribus*, a shift in the composition of FDI from primary and manufacturing sectors towards services could be expected to exacerbate its overall trade-balance impact. Indeed, such a shift had already started in the 1990s but accelerated in the new millennium. In the early 1990s, services had accounted for some 45% of total FDI inflows to EDEs, and this proportion averaged almost 60% during 2010-12 (Chart 6). During the same period, the share of manufacturing in total FDI inflows to EDEs fell from 36% to 27%, 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 linked to 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 more and more 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, we should 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 to different degrees. Inward-oriented foreign outfits sell



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



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

mainly in the domestic market, while the principal outlets of outward-oriented TNCs are abroad. Foreign manufacturers established for tariff-jumping and market-seeking purposes fall into the former category and often account for more imports than exports. This is also true for most, though not all, foreign investment in services.

By contrast, foreign firms in natural resources, such as those in most parts of Africa, are generally outward oriented. Domestic sales constitute a tiny proportion of their total production, and they generate more exports than imports. Thus, their impact on the balance-of-payments tends to be positive. Operations connected 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 businesses is generally more import intensive than that of local firms. There is also evidence that wholly foreign-owned companies are more import intensive than joint-venture establishments. On the other hand, in countries closely integrated into international production networks, such as China, Southeast Asian EDEs, and Mexico, the average import inten-

sity or foreign value-added content of exports is higher than those that 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 the 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 organizations 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 corporations to GDP and GNI tends 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 given their pronounced 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 widened their shares of world manufactured exports 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 moved up, while its ranking 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 EPZs have few supply-and-demand linkages with the economy other than 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 investors may not justify the costs incurred.

The main policy challenge for those EDEs that are part of the international production networks in manufactures is to get more of a contribution from

their foreign “partners” to the balance-of-payments, employment, and domestic value-added; their strategy, however, should be to reduce the import content of the foreigners’ production, not 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 the export orientation of foreign firms. That FDI would have a negative impact in countries where it is concentrated in areas with little or no export activity is incontrovertible. However, the discussions above suggest that this may also be the case even in countries with a strong presence of export-oriented foreign corporations, as a result of their high import intensity and profit remittances.

This appears to be what happened in several Southeast 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 turned out that while FDI had fueled much of the expansion of exports it had also led to a hike in imports as well as royalty and license fees and profit remittances. About 90% of all machinery and equipment used for foreign investment projects and 50% of raw materials are estimated to have been imported. From the mid-1980s until 1991-92, exports as a percentage of GDP rose from 29% to 36%, while imports powered ahead from 25% to 40%. All of this swelled the current-account deficit more than the crest in FDI inflows and contributed to the build-up of external debt that culminated in the 1997 crisis.

A study of Malaysia also estimated that the impact of foreign direct investment on the current account, including the initial imports associated with FDI inflows, was negative in every year during 1980-1992, and this was offset by FDI inflows 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, with new FDI inflows matching or exceeding these deficits in only five years.

There is also evidence from other countries with a large contingent of outward-oriented foreign players in the services and manufacturing sectors. India is one of them. As noted, FDI has been central to the successful performance of its services exports. Still, the overall impact of FDI on the Indian current

account appears to have been negative in the 1997-2011 period (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 companies imported 55% of raw materials and intermediate goods; this was more than double that of domestic producers. Overall, FDI actually hurt the balance of payments and contributed to the persistent deficits in manufacturing due to the foreigners' high propensity to import production inputs.

China's experience as a top recipient of export-oriented FDI reveals several interesting features and lessons for countries wanting to be a part of the international production networks, which have been established and are 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 number-one recipient of FDI in the developing world in the 1990s. The trade deficits of foreign firms reflected those in the non-processing trades since export-oriented operators in the 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 locals active in the processing trade – 78% compared to 66%.

More recent research, based on input-output data and accounting for indirect as well as direct import content, 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 the domestic value-added content. According to an estimate, the share of foreign value-added in China's processing exports tumbled from 79% in 1997 to 62.7% in 2007, and in its total manufactured exports from 50% to 40% (Koopman *et al.*, 2012).

This resulted in a huge improvement in the trade balance of foreign affiliates in China in the new millennium. Indeed, exports by foreign-funded corporations, including wholly foreign-owned and joint-venture institutions, 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 negative, with income

payments exceeding the portion of the trade surplus generated by them. This implies that, unless the import intensity of foreign affiliates is slashed, China

**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*.

could face growing current-account deficits caused by them as income payments on the stock of FDI mount.<sup>11</sup>

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 the 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% of the income paid on FDI liabilities.

It is not clear if China can keep running surpluses on its current account. Its surplus has already declined, from a peak of 10% of GDP in 2007 to less than 2% in 2013-14. There is wide agreement that China needs to up its 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

<sup>11</sup> An earlier study of 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).

demand, its trade surplus can shrink rapidly and may even fall below the amount equal to 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 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% in the mid-1990s to the current share of about 35%" (Constantinescu *et al.*, 2014, pp. 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 the foreign investors. These costs can be quite onerous in a forex-constrained economy. Deficits run by the foreign corporate community 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 the 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% 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, p. 144), which could eventually entail significant transfers of resources. Thus, it might be cheaper to make the same investment with borrowed money.

## 6. 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 the 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. Deliberately 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 companies, 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 one 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 corporations. 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 have 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 economies of host countries occur include competition, imitation, demonstration, and labor turnover. However, the impact is not always benign. The high productivity and competition they bring could help improve the efficiency of local businesses, but these can also block entry of the latter into high-value production lines or drive them out of business. They can prevent rather than promote infant-industry learning unless the locals are supported and protected by tailor made policies. Local firms can learn and imitate more easily when their foreign competitors establish forward and backward linkages with

them instead of relying on linkages abroad. Domestic linkages are also essential for the integration of local firms into the global market. Foreign affiliates can have a notable impact on industrial structure if they invest in relatively technology-intensive industries and relocate some of their R&D activities to 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 if they focus on labor-intensive sectors or import labor 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, p. 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 effect of FDI depends on a host of other variables that are endogenous to the growth process. Positive spillovers from foreign companies can become marked only when there is already in place an appropriate level of local capabilities. Even then, policy in host countries is central to 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 that exploited it for purposes of national industrial policy that was itself designed to shape the evolution of specific industries with the goal of accelerating industrialization and growth. In fact, the wide-ranging presence of foreign corporations 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 discouraging 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 much 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—or, for that

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



matter, the second-tier NIEs, notably China, Malaysia, and Thailand. As in Japan, they focussed 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 licensing. They also used original equipment manufacturers (OEM) to induce foreign investors to supply technological information and integrate local enterprises 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. Licensing 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 set up in many locales, not only for balance-of-payments reasons, but also to foster 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, especially those from Japan.

Although both Hong Kong and Singapore relied heavily on FDI, there were important differences in the policies pursued and therefore the contribution of FDI to industrialization. While Hong Kong followed a *laissez-faire* policy towards FDI, Singapore targeted specific industries for support, offering incentives and imposing 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 to the rapid upgrading and industrial success of Singapore.

Among the second tier-NIEs, Malaysia and Thailand have followed a liberal approach towards FDI, allowing fully-owned foreign subsidiaries. However, after 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, with highly interventionist policies. It started like Malaysia and Thailand, combining low-skilled assembly activities with high-technology imported parts, but it then 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 companies, not only in Japan but also in Korea (Zhu, 2012).

## **7. Multilateral and Bilateral Constraints on Investment Policy**

The experience strongly suggests that policy interventions would be necessary to contain the adverse effects of FDI on stability, the 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 maneuver. There are two main sources of constraints on 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 the commercial presence of foreign enterprises (the so-called mode 3) in the services sectors. In addition to these, a number of other agreements provide for limits, 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 the prohibition of (1) domestic-content requirements, whereby an investor is compelled or provided an incentive to use domestically produced rather than imported products; and (2) foreign-trade- or foreign-exchange-balancing requirements linking imports by an investor to its export earnings or to the for-

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

<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).

eign-exchange inflows attributable to investment. By contrast, in TRIMs or the WTO more broadly, there are no rules restricting beggar-thy-neighbor investment incentives offered by recipient countries that are equally trade distorting. Such incentives provide an 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 thrown together via international production networks that are controlled by TNCs (Kumar, 2002).

The obligations under TRIMs may not greatly affect 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; they also lack capital-goods industries. Linkages with domestic industries are usually weak, and output is almost fully exported. The domestic content of production by foreign companies is mainly limited to labor and some intermediate inputs. The main challenge is how to push local processing so as to increase domestic value-added. However, over time, restrictions on domestic-content requirements can reinforce the “resource-curse syndrome,” as the country wants to undergird resource-based industries, to transfer technology to local firms, and to establish backward and forward linkages with them.

Restrictions on domestic-content requirements are particularly a concern for investors in manufacturing in countries at intermediate stages of industrialization, especially in the automotive and electronics industries – the two key sectors where they were successfully applied in East Asia. As noted, most industries in EDEs that are part of international production networks have high import content 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 a pivotal step in industrial upgrading. Restrictions on domestic-content requirements would thus limit transfer of technology and import substitution in industries that are connected to international production networks.

However, TRIMs’ provisions leave certain flexibilities that could give EDEs the room to move in order to multiply the 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 limits on 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 wielded to discourage exports of unprocessed miner-

als 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 prescribed 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 license for an automotive assembly plant only if it simultaneously establishes a plant to produce the engines, gearboxes, or electronic components for the cars. Similarly, licenses for a computer assembly plant could be made conditional on the establishment of a facility for manufacturing integrated circuits and chips. Such measures would raise the domestic value-added and net export earnings of TNCs and not contravene the provisions of the TRIMs agreement.

Third, there might be export-performance requirements without reference 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, p. 177). Finally, the TRIMs regime does not prevent governments from 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 resorted to 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 for foreign companies in order to help develop national capabilities in the services sectors. However, this would be possible only 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 EDEs' latitude in policymaking 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 when one examines the wide-ranging provisions in favor of investors. These include broad definitions of investment and investor, the free transfer of capital, rights to establishment, the national treatment and the most-favored-nation (MFN)

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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 policymaking in Malaysia.

clauses, fair and equitable treatment, protection from direct and indirect expropriation, and prohibition of performance requirements (Bernasconi-Osterwalder *et al.*, 2012). Furthermore, the reach of BITs has been 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 a 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 (Bernasconi-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 deployed 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 have 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, on that basis, 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-

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<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 make 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).

Argentina BIT, representing an intervening in 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 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, or rapid depletion of reserves could need temporary debt standstills and exchange controls in order to prevent a financial meltdown (Akyüz, 2014). However, such measures might be deemed illegal under the “free transfer of capital” provisions of BITs.

Where rights of establishment are granted, the flexibilities in the TRIMs regarding the entry requirements noted above would simply disappear. The national-treatment clause in BITs requires host countries to treat foreign investors no less favorably than its own national investors and, in so doing, prevents them from protecting and supporting infant industries against mature TNCs and bolstering 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.

Furthermore, 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 those signed in recent years incorporate explicit no-go areas (Nikièma, 2014). Some BITs go beyond TRIMs and bring additional bans on 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, as it allows investors to challenge the TRIMs-compatibility of host-country actions outside the WTO system. This ups 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 the more favorable rights and protection granted to foreign investors in agreements with third-party countries.<sup>17</sup>

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 the policymakers in host countries. Evidence suggests that BITs are neither necessary nor sufficient to bring in 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 of the impact of BITs on FDI flows are highly ambivalent. While a few of them 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 assessors of political risk or in-house counsel in large US corporations do not pay much attention to BITs when weighing in on investment decisions (Yackee, 2010).

## 8. Conclusions

Unlike the philosophy inherent in the dominant corporate ideology, FDI is not a recipe for the rapid and sustained growth and industrialization of EDEs. A hands-off approach to FDI, as to any other form of capital, can lead to more

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

harm than good. FDI policy needs to be embedded in the overall industrial strategy in order to ensure that it contributes positively to the 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 clear benefits to be gained in terms of managerial skills and follow-up investments;
- 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 measurable positive spillovers from FDI;
- FDI contains speculative components and generates destabilizing impulses that need to be controlled and managed, like 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 the employment and training of local labor, local procurement, domestic content, export targets, and relationships 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.

The ability to establish policy guidelines 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 salient reasons for EDEs to avoid negotiating the kind of BITs promoted by AEs. They need to turn their attention to improving their underlying economic fundamentals rather than pinning their hopes on BITs to attract FDI. Where commitments undertaken in existing BITs seriously impair their ability to harness



FDI for industrialization and development, they should be renegotiated or terminated, as is being done by a number of EDEs, even if doing so may carry some immediate costs in its wake.

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