

INTRODUCTION

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

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

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

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

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

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

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

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

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

GENERAL CHARACTERISTICS OF THE COUNTRIES IN THIS STUDY

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

Table 1. General characteristics of the countries in this study

<i>Market size</i>	Argentina	Brazil	Chile	Indonesia	Malaysia	Philippines
GNP per capita (US\$) 1995	8 030	3 640	4 160	980	3 890	1 050
Population 1995	35	158	14	194	21	70
GNP (US\$ million) 1995	281 050	575 120	58 240	190 120	81 690	73 500
<i>Trade</i>						
Share of world exports 1994	0.34%	0.81%	0.24%	0.74%	1.05%	0.38%
Export growth 1988-9 to 1992-3	8.6%	3.1%	7.7%	12.1%	17.0%	10.4%
Manufactured share of exports	32%	60%	18%	53%	70%	76%
High-technology share of mfg. exports	16%	na	16%	16%	67%	42%
Exports as percentage of GDP, 1995	9%	7%	29%	25%	98%	36%
Economic activity of SOEs as percentage of GDP, 1986-91	4.7%	8.6%	12.9%	14.1%	17.0%	2.4%

Source: World Bank

The six countries in this study are among the most important recipients of inward investment outside of the OECD area (Table 2). With the exception of the Philippines, all countries have been among the top ten non-OECD recipients of FDI in the 1990s. Four of the countries are also among the top 20 global recipients of FDI. Although the three Asian countries in the study are prominent hosts for FDI in the non-OECD area, they have still received only 42 per cent as much investment in the 1990s as China. Indeed, the rapid rise of China in this decade has been perceived as a threat by some of these countries in terms of their continued ability to receive substantial amounts of inward investment.

Table 2. **Total FDI inflows by country, 1990-96**

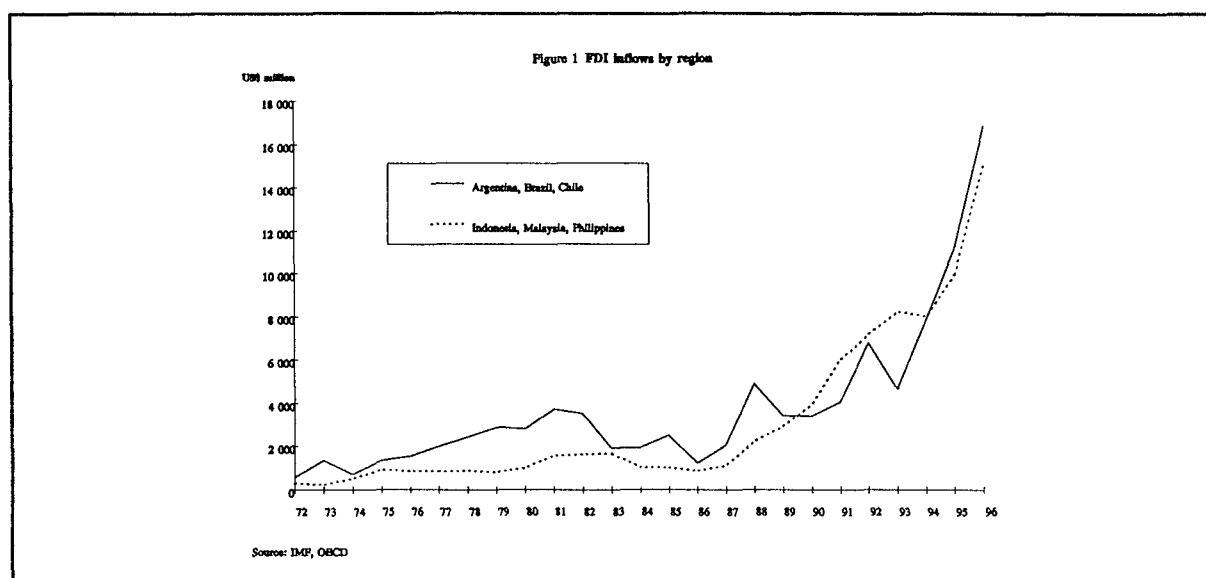
	US\$ million
1 US	327 074
2 China	158 462
3 UK	146 671
4 France	124 850
5 Belgium-Luxembourg	68 526
6 Spain	62 737
7 Netherlands	49 881
8 Canada	44 921
9 Australia	44 468
10 Mexico	40 222
11 Singapore	39 176
12 Sweden	38 188
13 Malaysia	31 967
14 Italy	26 534
15 Brazil	22 876
16 Argentina	22 409
17 Germany	21 663
18 Indonesia	20 773
19 Denmark	15 810
20 New Zealand	15 286
21 Switzerland	15 170
22 Thailand	14 238
23 Hungary	12 508
24 Hong Kong	11 639
25 Portugal	11 081
26 Poland	11 075
27 Norway	10 720
28 Chile	10 152
29 Colombia	9 814
30 Peru	9 540
31 Nigeria	9 051
32 Chinese Taipei	8 644
33 Austria	8 576
34 Japan	7 086
35 Philippines	7 017
36 Czech Republic	6 499
37 Korea	6 450
38 Venezuela	6 379
39 Greece	6 295
40 India	5 684

n.b. Definitions of FDI differ greatly across countries.

Source: OECD, IMF, UNCTAD

I. FDI TRENDS IN SOUTHEAST ASIA AND SOUTH AMERICA

The trend in inflows into each region, based on the six countries of the sample, can be seen in Figure 1. Historically, the three Latin countries have received far more than those in Southeast Asia, although this situation was reversed in the early 1990s. Investment in South America has tended to be more volatile, with a sharp decline following the eruption of the debt crisis in the early 1980s. By 1993, in real terms, investment in the three Latin economies was still lower than it had been at the start of the debt crisis. The Asian countries have seen foreign investment rise steadily since the mid-1980s, while for South America the upward thrust has come only in the past three years. In both cases, however, the change has been impressive. Combined inflows in 1990 were just over US\$7 billion; by 1996 the total was US\$32 billion. Inflows in the past five years have exceeded by a comfortable margin inflows in the previous 20 years (in nominal terms).



Independently of any potential policy reforms, the ongoing financial crisis in Asia will affect FDI flows into those countries through several different channels, some of which work in opposing directions. Since a significant share of FDI into both regions is to supply goods and services to the local national and regional markets, slower growth will lead to less FDI, just as it does for domestic investment. This is particularly true for investments in the automotive sector. Cars and other vehicles are usually bought on credit, and hence demand has been severely depressed in the short term by the rise in interest rates to defend existing parity levels of the currency and by the rise in the car tax in Brazil.

Before recent events, foreign automotive producers had committed themselves to investing over \$13 billion in Brazil alone in the next few years. They have already invested substantially in Thailand. In the long run, the reasons for investing have not changed. These markets still offer better long term growth prospects than in home countries, but in the short run, some projects may be delayed.

At the same time, the nature of investment in these countries might change in ways which will encourage further inflows. Exchange rate movements in the Asian countries will make them more attractive as locations for export production. Exchange rate realignments mean that many of the Southeast Asian currencies have depreciated by over 30 per cent against the dollar since July. This will assist

national economies as they try to compensate for depressed local demand by exporting. While they will have little advantages over each other because all currencies have fallen, they will have gained some advantage over Chinese exports. This exchange rate advantage will be offset to some extent by the high import content of many of the principal exports from Southeast Asia, particularly for those goods produced by foreign MNEs. For MNE-affiliated exporters in electronics, for example, imports represent on average 80 per cent of the value of exports. But even domestic exporters are sometimes dependent on foreign partners for imported components. Proton of Malaysia, for example, imports engines and other technological components from its Japanese partner.

Another economic influence of exchange rate movements on FDI decisions arises through the effects of currency depreciation on the stream of dividends from the affiliate back to the parent. Recent experience in Mexico appears to suggest that this effect will not deter investments because of the offsetting gains in terms of the ability to acquire local assets more cheaply and the greater scope for exports. The crisis might also spur greater intra-regional investments, especially from countries relatively unaffected by recent events, such as Singapore. Not only are assets in neighbouring countries much cheaper, but the owners are also much more likely to be willing to part with control of the company. There is already evidence that cross-border mergers in Asia are growing.

Characteristics of FDI in each region

OECD investors are, collectively, the most active investors in each of the six countries. There are nevertheless important differences across source countries, with a clear regional bias visible in investment patterns. Japanese firms have shown a strong preference for investing in Asia, while US and European firms are more strongly represented in the three Latin economies (Table 3)². The regional bias is most pronounced in the three South American countries, where Japan has a significant presence only in Brazil. The Table 3 also demonstrates the extent to which OECD firms prefer the richer South American markets to those in Asia. The fact that the Asian countries nevertheless ranked highly in Table 2 testifies to the importance of intra-regional flows involving non-OECD investors in Asia.

Table 3. OECD investments by major investor
(cumulative flows 1985-95, US\$ million; per cent)

<i>Host</i>	<i>Home</i>			
	OECD	Europe	US	Japan
Argentina	10 967	37%	58%	4%
Brazil	34 858	24%	62%	14%
Chile	7 093	30%	64%	5%
Indonesia	15 941	10%	19%	65%
Malaysia	11 591	26%	19%	50%
Philippines	5 434	25%	23%	48%

Source: *International Direct Investment Statistics Yearbook*, OECD

²The information provided in Table 3 is based on home country data reporting and therefore differs from what host countries record as inflows in Table 2. Some of this discrepancy relates to investments from non-OECD countries, but this is likely to be a major factor only in Malaysia. The comparison of the two tables suggests that inflows into Argentina may be overstated by the host country, while inflows into Brazil are grossly understated. These differences are likely to be explained partly by different reporting methodologies and definitions of FDI.