

PART I
Chapter 2

Trends in foreign direct investment and their implications for development

by

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Foreign direct investment can play an important role in financing development, with multinational enterprises also providing employment, technology transfer and access to international markets. Between 2005 and 2014, foreign direct investment flows to non-OECD countries more than doubled in absolute terms since 2012, these countries receive more than 50% of the global total, compared to 35% in 2005. Recently, however, some types of international investment in emerging and developing economies have started to decline. There are important warning signs that these investment flows could experience a sharp slowdown over the coming years (or could even reverse in some cases). This chapter examines these trends, the main factors shaping them and their implications.

Challenge piece by Karl P. Sauvart, Columbia Center on Sustainable Investment. Opinion pieces by Andrew Chipwende, Industrial Development Corporation, Zambia; Shaun Donnelly, United States Council for International Business; James Zhan, United Nations Conference on Trade and Development.

The challenge: How can foreign direct investment fulfil its development potential?

Karl P. Sauvant,

Resident Senior Fellow, Columbia Center on Sustainable Investment, Columbia University

International investment, and in particular foreign direct investment, has an important role to play in helping to achieve the Sustainable Development Goals. It can be a powerful international mechanism for mobilising the tangible and intangible assets (such as capital, technology, skills, access to markets) that are essential for sustainable growth and development.

Yet to fulfil this potential, foreign direct investment must increase substantially; it must be geared as much as possible towards sustainable development; and it must take place within a framework of international investment law and policy that is enabling, yet at the same time respectful of host governments' own legitimate public policy objectives.

Foreign direct investment flows reached their peak in 2007 at around USD 2 trillion, dropping to USD 1.2 trillion by 2009 as a result of the international financial crisis. While this represents a relatively small share – about 10% – of gross domestic capital formation, in individual countries this share can be even higher than domestic investment.

To help meet the investment needs of the future, these flows have to increase substantially. There is no apparent reason why they could not do so over the longer term, say to a level of USD 4 or 5 trillion annually.

How to get there? Improving the economic determinants, the principal factors governing investment decisions, is fundamental. Official development assistance will continue to be important, especially for the least developed countries, including to leverage higher foreign direct investment flows. This is a long-term challenge.

However, national regulatory frameworks and investment promotion efforts can be improved in the short term, especially in the least developed countries.

The first challenge is to increase foreign direct investment through a concerted international effort to help developing countries, and especially the least developed among them, to improve their foreign direct investment regulatory frameworks and investment promotion capacities. At present, there is no such international effort – along the lines of the Aid-for-Trade Initiative and especially the Trade Facilitation Agreement – in the area of foreign direct investment. But in a world of global value chains, these trade arrangements can help only so much, precisely because they address only one side of the task, namely to increase trade. But a concerted international effort for foreign direct investment, such as an international Aid-for-Investment Initiative or even a Sustainable Investment Facilitation Understanding, could help developing countries, and especially the least developed among them, rapidly to improve their regulatory frameworks as well as their capacity to promote investment – thereby helping to increase investment flows to developing countries.

Encouraging higher foreign direct investment flows is, however, not enough.

The second challenge is to promote foreign direct investment that is geared as closely as possible towards sustainable development: “sustainable foreign direct investment for sustainable development”. This presents the challenge of defining “sustainable foreign direct investment”. A first approximation could be: commercially viable investment that makes a maximum contribution to the economic, social and environmental development of the host country and takes place in the context of fair governance mechanisms, as established by host countries and reflected, for instance, in the incentives they offer. Yet any definition needs to be operationalised. So this challenge would also involve developing an indicative list of sustainability characteristics to be considered by governments seeking to attract sustainable foreign direct investment (and to encourage sustainable domestic investment). Such a list would also be a helpful tool for international arbitrators considering (as they should) the development impact of investments, as well as for identifying the mechanisms – beyond those deployed to attract foreign direct investment in general – that encourage the flow of sustainable investment and increase its benefits for host countries.

The third challenge is to reform the international investment law and policy regime. National foreign direct investment rule making increasingly takes place in the framework of international investment law and policy. For this reason, it is important to ensure that the international investment regime constitutes an enabling framework for encouraging the flow of sustainable foreign direct investment, while at the same time allowing governments to pursue their legitimate public policy objectives. This requires asking several questions, including: How can the objective of sustainable development be made the lodestar of the international law and policy regime? What are the implications of such a concept for the regime's rights and obligations? How will this affect the mechanism for settling disputes between investors and states? This last function is central to the regime and gives it its strength, yet it is precisely the existing dispute-settlement mechanism that is strongly questioned – especially by non-governmental organisations, but also by a number of governments. Any reform needs to address this challenge adequately to avoid threatening the very legitimacy of the regime.

In conclusion, governments need to find ways and means to increase sustainable foreign direct investment flows within a reformed international investment law and policy regime to realise the sustainable development potential of this investment.

Until 2002, foreign direct investment by multinational enterprises was widely viewed with suspicion, if not outright hostility. Multinationals were seen as icons of irresponsible business conduct and as instruments of political interference and neo-colonialism. In some instances this was true. Over time, however, more and more governments have come to recognise that the case for investment protectionism – on the grounds that foreign investment was, on balance, bad for development – had been overstated. In 2002, the Monterrey Consensus fundamentally transformed the development agenda by explicitly recognising that rather than being part of the problem, foreign direct investment can play an important role in financing development objectives. Many developing countries had already figured this out; for others, multinational enterprises have increasingly come to be seen as promising sources of employment, technology transfer and access to international markets.

This shift in attitudes motivated two high-profile attempts to negotiate multilateral rules that would facilitate international investment: the World Trade Organization Doha Round and the OECD Multilateral Agreement on Investment negotiations. Although these attempts failed, across the developing world a less conspicuous – yet transformational – agenda for domestic investment policy reform has led to greatly improved business climates, with impressive results. Between 2005 and 2014, foreign direct investment flows to non-OECD countries more than doubled in absolute terms; since 2012, these countries have accounted for more than 50% of the global total, compared to 35% in 2005 (Figure 2.2). More recent trends, however, are less encouraging. Some types of international investment in emerging economies are starting to decline: project finance, mainly for infrastructure, fell by a third over 2014-15 (Figure 2.7). Record-high corporate debt levels, slowing growth and the prospect of an increase in US interest rates are, in addition, providing restraints for would-be foreign investors in emerging markets.

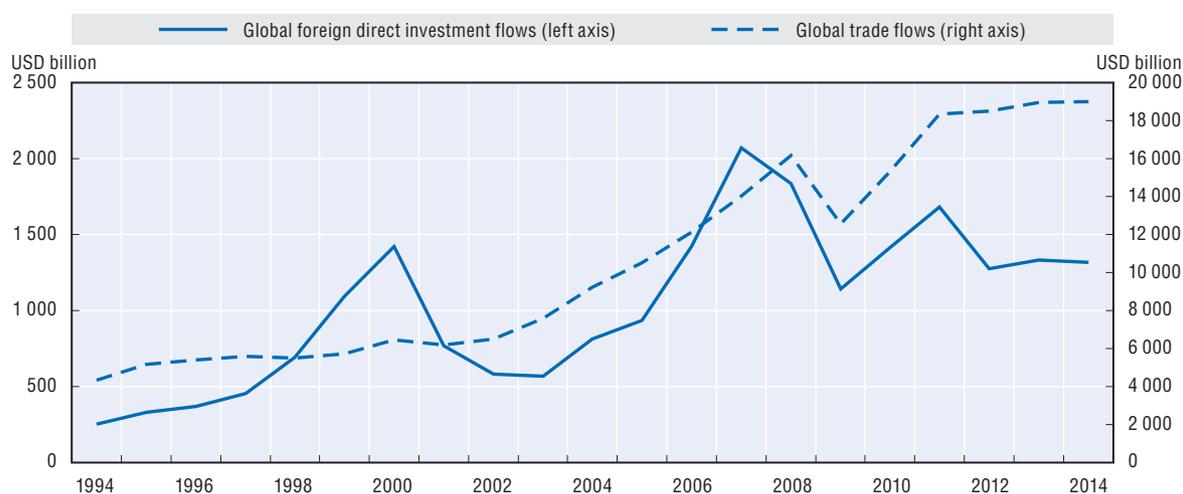
With the challenge of financing the Sustainable Development Goals (SDGs) looming large, many are looking to foreign direct investment as a means of filling the financing gap (see the challenge piece by Karl P. Sauvant at the beginning of this chapter). This chapter examines recent trends in cross-border investment flows to developing countries and looks at the main factors shaping the outlook. It flags important warning signs that investment flows to the emerging and developing countries could experience a sharp slowdown over the coming years, in some cases even reversing.

The global foreign direct investment slump continues

Persistently low levels of private sector investment since the start of the financial crisis in 2008 have constituted a major source of concern for policy makers, with the current global foreign direct investment slump proving much more tenacious than the crash that followed the collapse of the dot-com bubble in 2001. While global flows started to recover only two years after the 2001 crash, eight years into the current slump these flows remain 36% below the levels reached in 2007 and 7% below the 2000 levels (Figure 2.1). This poses major questions for the development co-operation and investment policy communities: is there an element of permanence to these declines? And if so, what does this imply for developing countries?

The current global foreign direct investment slump is proving tenacious.

Figure 2.1. **Global trade and investment flows, 1994-2014**



Sources: OECD (2016), *OECD International Direct Investment Statistics* (database), <http://dx.doi.org/10.1787/bmd4-data-en>; WTO (2015), "Time series on international trade", *Statistics Database*, <http://stat.wto.org/Home/WSDBHome.aspx?Language=E>.

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On the one hand, the sluggish foreign direct investment flows would seem consistent with broader economic trends. Economic performance globally has remained weak since 2008, despite extraordinary monetary measures taken in advanced economies to boost growth. Destabilising geopolitical conflicts on multiple fronts and signs of economic fragility across the emerging markets have further undermined investor confidence. Consequently, rather than sparking the hoped-for investment rebound, the liquidity generated by quantitative easing (injecting money straight into the economy in response to reduced spending by businesses and citizens) has found its way into share buy-back programmes, debt-fuelled corporate expansion in emerging markets, and, most recently, a boom in corporate restructurings and mergers and acquisitions in developed economies.

In addition to the generally bleak economic conditions confronting investors, other factors would also seem to be holding back investment. This is reflected by the fact that international investment has been lagging behind other broad measures of economic activity, which it tends to follow closely. For example, while foreign direct investment flows are 36% below their 2007 levels, trade flows have grown by 36% over the same period (Figure 2.1). Growth in cross-border investment is also lagging behind that of domestic investment.

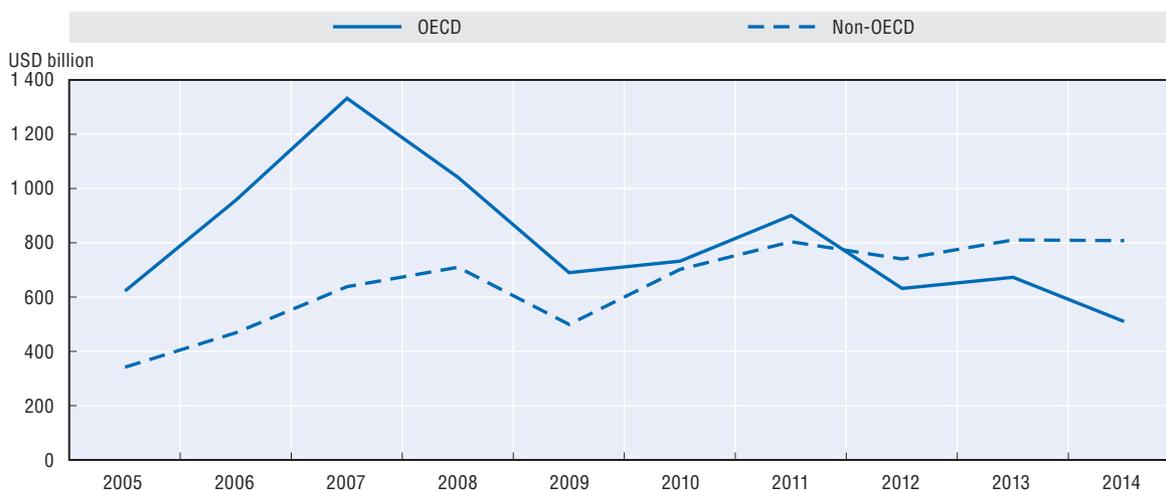
The global distribution of foreign direct investment is shifting

Foreign direct investment has enabled many developing and emerging economies to become much more deeply integrated into the global economy and global value chains in recent years. A look at global flows, however, shows that this overall trend masks nuanced patterns.

Inflows to non-OECD countries have overtaken those to OECD countries

Trends in foreign direct investment inflows into the developing economies as a group have not generally followed the global trends outlined above. At the peak of the foreign direct investment boom in 2007, OECD countries received around 70% of all foreign direct investment inflows. In a span of only seven years, however, this share dropped to around 40%, with inflows to non-OECD countries overtaking those of the OECD country grouping for the first time in 2012 (Figure 2.2).

Figure 2.2. **Foreign direct investment inflows by broad country groupings**



Source: OECD (2016), *OECD International Direct Investment Statistics* (database), <http://dx.doi.org/10.1787/bmd4-data-en>.

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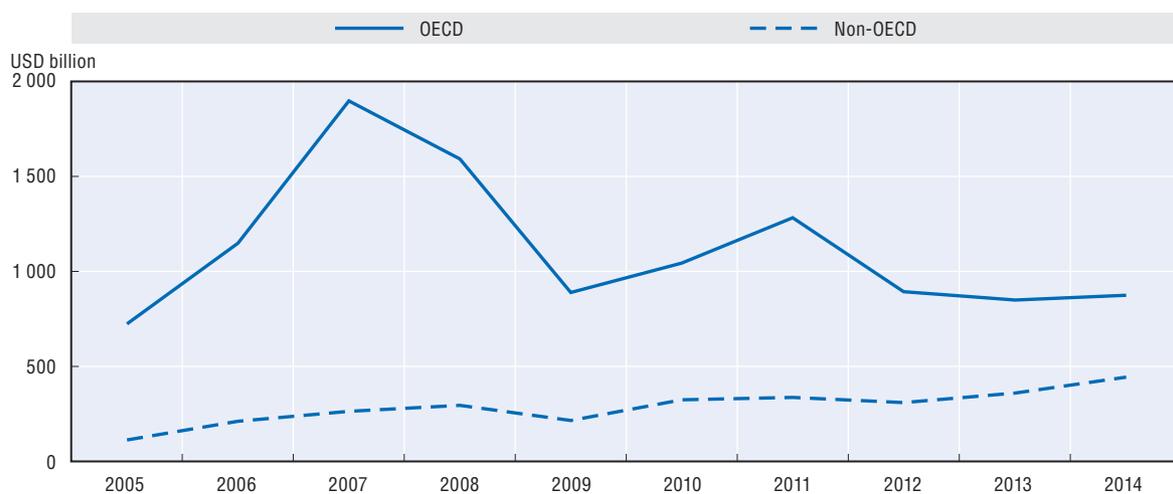
The growth of foreign direct investment inflows to emerging countries, excluding the People's Republic of China (hereafter "China"), has been distributed relatively evenly, with non-G20 emerging economies receiving USD 350 billion (44%) and the G20 emerging economies¹ excluding China receiving just over USD 150 billion (20%) in 2014. In that same year, China received around USD 300 billion in foreign direct investment, representing 36% of flows to all developing countries (Figure 2.3). Within the group of non-G20 emerging economies, these flows increased more or less proportionally across all regions. China offers an exception to this general trend, given the spectacular growth of its inward and outward investment flows in recent years.

Outflows from non-OECD economies have quadrupled

While the shifts in global distribution of outflows have been less dramatic than for inflows, they have, nonetheless, been significant. Before the crisis, OECD countries accounted for around 90% of global outflows, reaching USD 1.9 trillion in 2007. By 2014, OECD country outflows had declined by USD 1 trillion, to 66%. In contrast, non-OECD country outflows quadrupled between 2005 and 2014, from USD 112 billion to USD 443 billion (Figure 2.4). As with inflows, China stands out as a special case, accounting for just under 20% of all emerging market foreign direct investment outflows over the same period (Figure 2.5).

Figure 2.3. **Breakdown of foreign direct investment inflows to emerging economies**

Source: OECD (2016), OECD International Direct Investment Statistics (database), <http://dx.doi.org/10.1787/bmd4-data-en>.
StatLink  <http://dx.doi.org/10.1787/888933357570>

Figure 2.4. **Foreign direct investment outflows by broad country groupings**

Source: OECD (2016), OECD International Direct Investment Statistics (database), <http://dx.doi.org/10.1787/bmd4-data-en>.
StatLink  <http://dx.doi.org/10.1787/888933357589>

This “redistribution” of foreign direct investment over the past decade in favour of the emerging markets is welcome for a number of reasons:

- The emerging markets have played a counter-cyclical role, helping to maintain international investment levels even while the traditional foreign direct investment players were experiencing slumps. Although the current global foreign direct investment slump has been longer than the one experienced in 2001/02, the overall decline has been relatively smaller thanks to the increase in flows from the emerging markets.
- This rebalancing has brought about a more even distribution of the benefits associated with international investment, as economies at all levels of development have been increasingly integrated into global value chains.
- The blurring of lines between investor and “host” countries has been credited with giving rise to a certain convergence of views on international investment rule making.

Figure 2.5. **Breakdown of foreign direct investment outflows from the emerging economies**

Source: OECD (2016), OECD International Direct Investment Statistics (database), <http://dx.doi.org/10.1787/bmd4-data-en>.

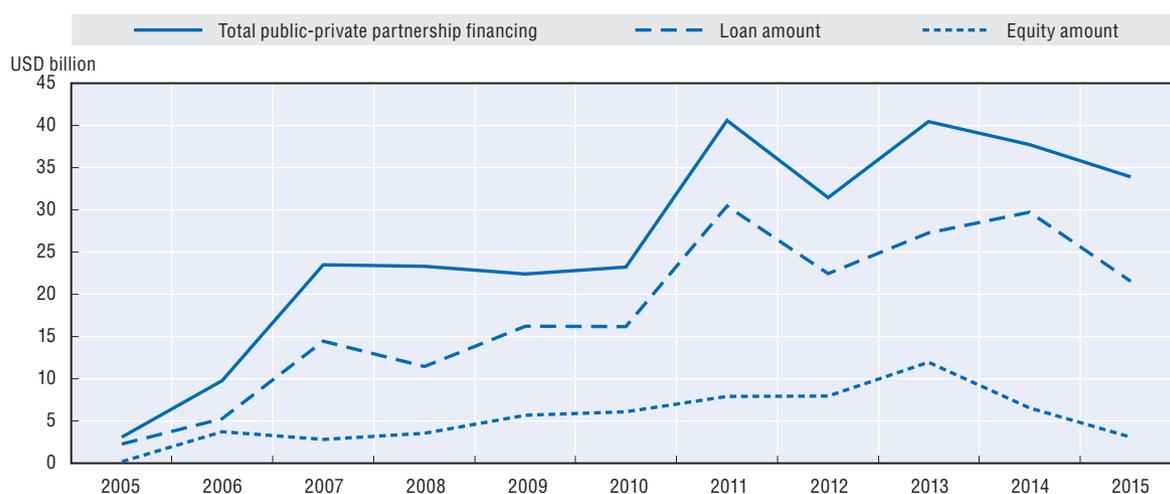
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Global investment trends show warning signs for emerging markets

Despite the broader involvement of developing countries in global investment, capital flows have started to decelerate and economic vulnerabilities seem to be growing (IMF, 2015). Just as the inevitable tightening of quantitative easing programmes in the advanced economies is expected to result in capital outflows from the emerging markets, it could likewise result in some turnaround in the rebalancing trend of foreign direct investment described above.

Public-private partnerships have started to decline

Some measures would seem to indicate that this reversal might already be under way. For example, looking at the specific case of investments in developing countries through public-private partnerships, until recently these had largely resisted the downward trend, reaching a record level of USD 40 billion in 2011 and again in 2013. Nonetheless, this trend has been reversing over recent years: public-private partnerships in developing countries declined by 7% in 2014 and by 10% in 2015 (Figure 2.6).

Figure 2.6. **Total public-private financing in developing countries**

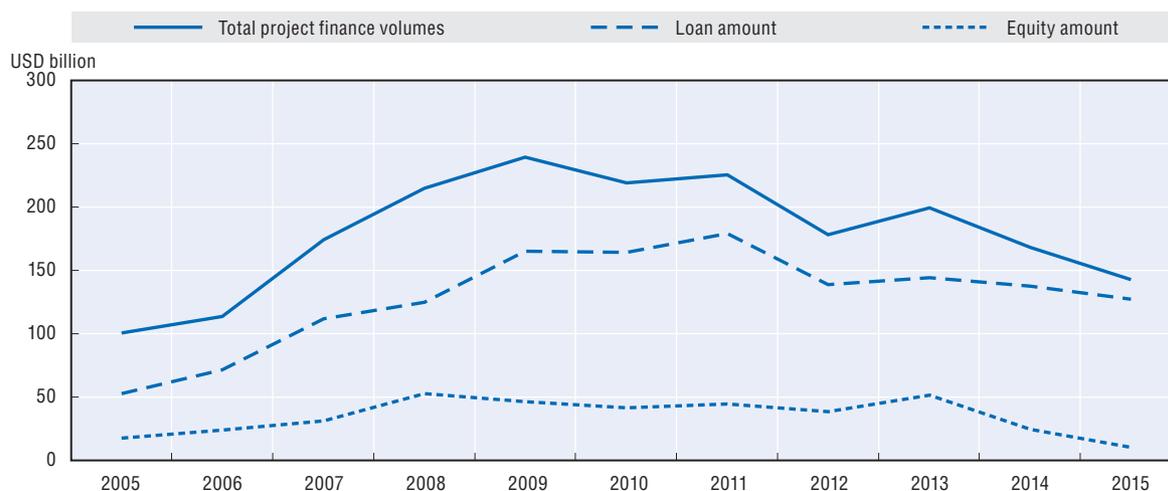
Source: Dealogic (2015a), Dealogic ProjectWare (database), www.dealogic.com.

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There has been a marked drop in project financing

Likewise, even as foreign direct investment inflows to the emerging markets have been increasing, since 2009 project financing² has dropped by around 40%. After reaching a record high of USD 240 billion in 2009, this financing is set to reach its lowest level since 2006 (USD 142 billion). Over the past two years, the equity component of project finance has also declined by 80% (Figure 2.7).

Figure 2.7. **Total project finance volumes in developing and emerging markets**



Source: Dealogic (2015a), Dealogic ProjectWare (database), www.dealogic.com.

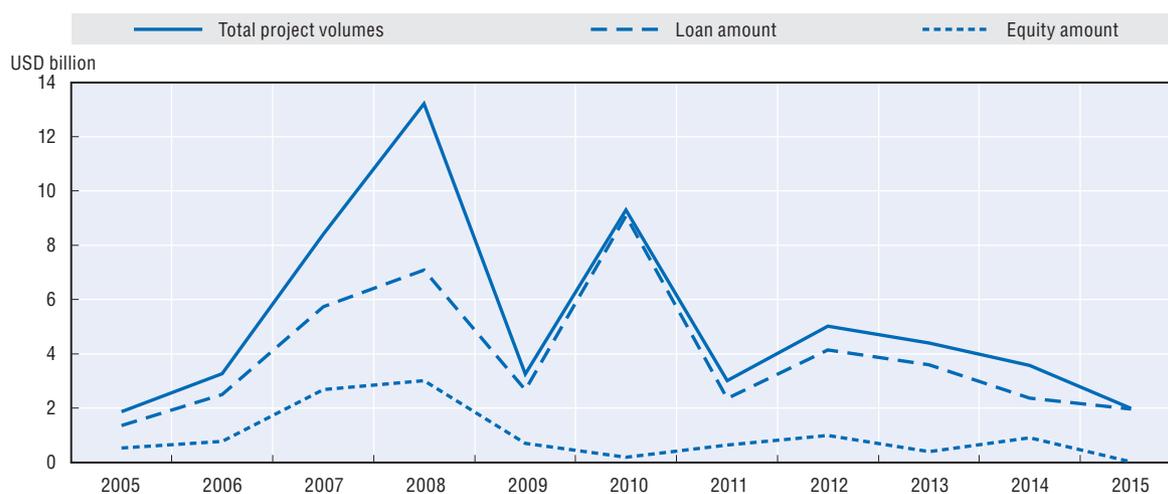
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Infrastructure projects in developing countries are now financed almost wholly via debt.

While the least developed countries account for a relatively small share of total developing country project finance (consistently less than 5%), these flows are especially important to them given their small size (economically) and their considerable infrastructure needs. Yet the decline in project financing has been particularly severe in these countries: after reaching a record high in 2008 (USD 13 billion), it fell to USD 2 billion in 2015, its lowest level in over a decade (Figure 2.8). Furthermore, much as in developing countries in general, the equity component of project financing for the least developed countries has fallen to insignificant levels, meaning that infrastructure projects in the least developed countries are now financed almost wholly via debt.

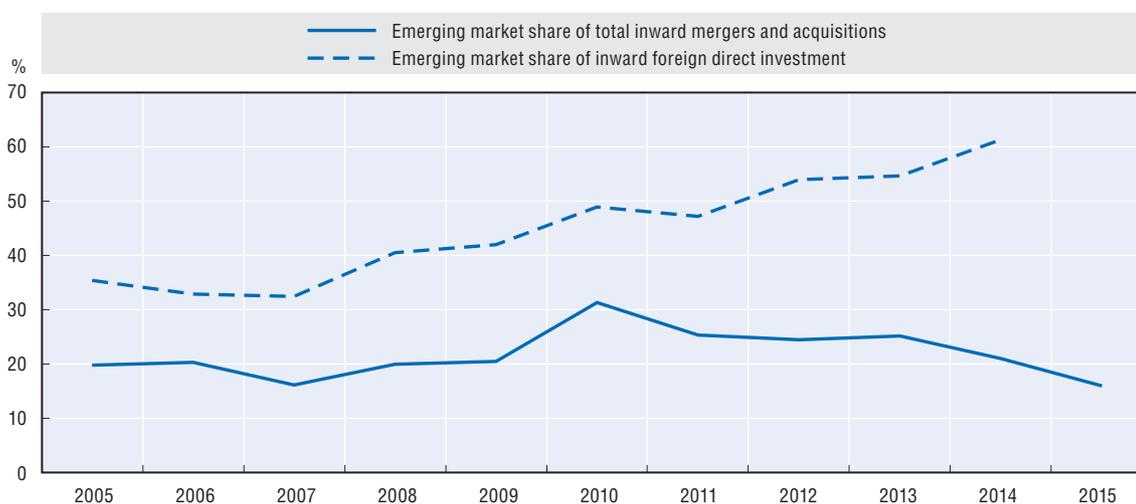
Cross-border mergers and acquisitions in developing and emerging markets have fallen

In addition to the decline in project financing, cross-border mergers and acquisitions into the developing and emerging markets have also declined over recent years: from USD 258 billion in 2011 to USD 162 billion in 2015 (Figure 2.9). Despite this general trend, however, the least developed countries have fared relatively well in this area, in large part thanks to inward mergers and acquisitions in the extractive sectors (see the “In my view” box by Andrew Chipwende later in this

Figure 2.8. **Project financing in the least developed countries**

Source: Dealogic (2015a), Dealogic ProjectWare (database), www.dealogic.com.

StatLink  <http://dx.doi.org/10.1787/888933357625>

Figure 2.9. **Emerging market inward foreign direct investment versus inward mergers and acquisitions**

Source: Dealogic (2015b), M&A Analytics (database), www.dealogic.com/investment-banking/ma-analytics.

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chapter). While in 2005 the least developed countries received only USD 600 million in cross-border mergers and acquisitions, between 2012 and 2014 they were receiving on average USD 10 billion a year (Figure 2.10), representing around 40% of their total foreign direct investment inflows.³ Nonetheless, in 2015 cross-border mergers and acquisitions in the least developed countries fell off sharply, by 70%, to just over USD 3 billion.

In 2015 cross-border mergers and acquisitions in the least developed countries fell by 70%.

*In my view:
African countries need institutions that will direct
investment to where it is needed most*

Andrew Chipwende,

CEO of the Industrial Development Corporation, Zambia

International investment has helped Zambia, like many other countries in sub-Saharan Africa, to become much more closely integrated into the global economy over recent years. Inward investment flows have doubled since 2008 and Zambia has even started to generate some modest foreign direct investment outflows.

Although the country has undertaken major structural reforms over the past two decades to make it a more attractive location for investment, the Zambian government realised that this was not enough. Research has shown that foreign direct investment in mining remains dominant, although flows to manufacturing and services have also shown an upward trend. And while the investment in mining has brought with it new technologies, there has been little impact on job creation.

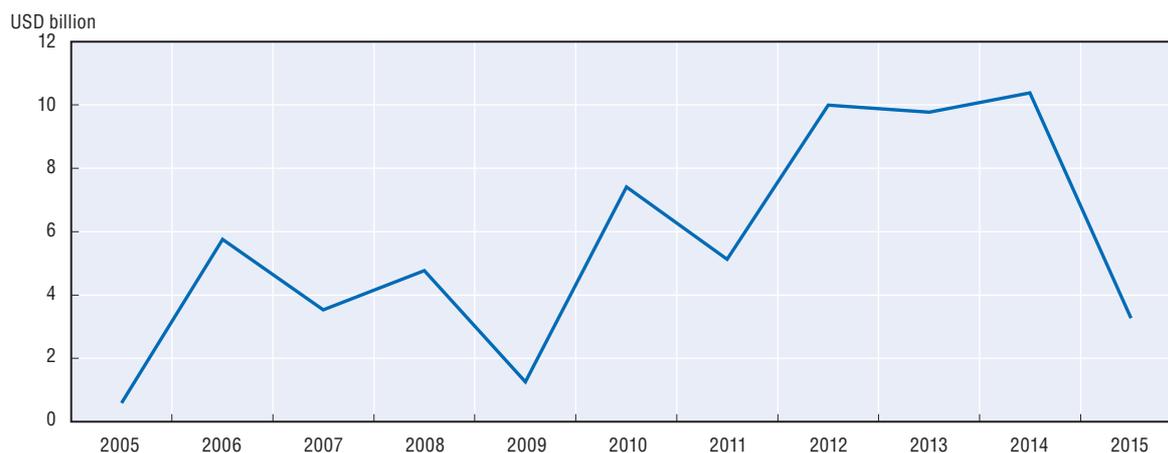
The government of Zambia created the Industrial Development Corporation (IDC) in January 2014 to help diversify investment away from mining. It aims to play a catalytic role in deepening and strengthening Zambia's industrialisation capacity, supporting the creation of jobs and domestic wealth across all key economic sectors. The IDC evaluates, assesses and lowers investment risk by serving as a co-investor alongside private sector investors, thereby facilitating long-term financing for projects. The IDC's initial investments in Zambia's growth sectors are helping to increase foreign direct investment and catalyse the introduction of new technology and industries. For example:

- In collaboration with the International Finance Corporation, a member of the World Bank Group, the IDC is leading the initial project development work for solar photovoltaic power stations of 50 megawatts (MW) each, reaching a total 600 MW capacity. The cost is expected to be in the region of USD 1.2 billion in foreign direct investment. The IDC is carrying out the early project development work – such as securing permits and power purchase agreements – which normally delays and hinders private investment. Once the solar projects have become bankable they will be offered to international developers to finance, build and operate.
- For the tourism sector, the IDC, in collaboration with the Ministry of Tourism and Arts, has set up a special purpose vehicle into which all government tourism-related assets will be grouped. These assets will be leveraged to raise funds and the company will serve as a co-investor with domestic and international tourism industry operators targeting investment in Zambia.

Zambia is fully aware of the challenges facing the global economy in general, and developing countries in particular. These challenges will very likely affect us.

In my view, we cannot let cyclical factors and trends distract us from pursuing our structural reform agenda to improve the business climate – not only in our own country but also across Africa. The IDC takes a long-term view in its investments, which helps projects and investors weather eventual storms.

The fact that both project finance and cross-border mergers and acquisitions in developing countries have declined since around 2011, while inward foreign direct investment flows have remained stable, is puzzling given that the former are important components of the latter. This suggests that other components captured in foreign direct investment statistics, namely reinvested earnings and intra-company loans, have been sustaining foreign direct investment flows since around 2011. Eventually one would expect these components to start moving in the same direction again, either with cross-border mergers and acquisitions increasing, or foreign direct investment flows shrinking.

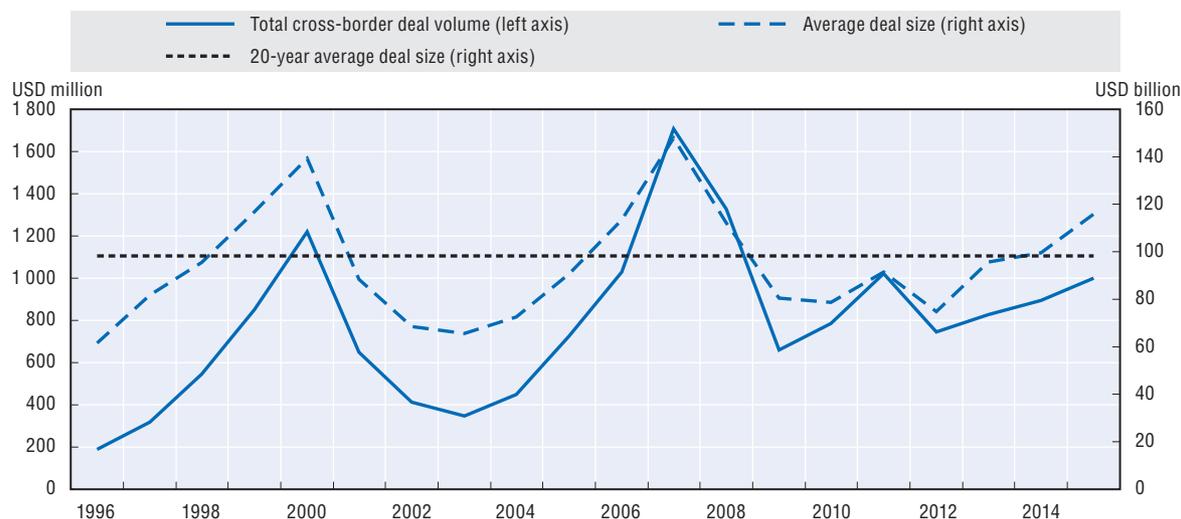
Figure 2.10. **Cross-border mergers and acquisitions in the least developed countries**

Sources: OECD (2016), OECD International Direct Investment Statistics (database), <http://dx.doi.org/10.1787/bmd4-data-en>; Dealogic (2015b), M&A Analytics (database), www.dealogic.com/investment-banking/ma-analytics.

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The sizes of cross-border deals are growing

There is one more source of concern for developing and emerging markets. In the lead-up to the two previous foreign direct investment crashes in 2001 and 2008, average cross-border deal values climbed to around USD 72 million as various factors, including easy financing, led firms to bid up cross-border merger and acquisitions prices. There are signs that this is happening again, although these deal values are still well below the levels reached in 2007 (Figure 2.11). This would indicate that foreign direct investment flows might be linked to a cross-border investment bubble generated by quantitative easing: easy financing conditions, combined with widespread industry consolidation through mergers and acquisitions in the face of slowing growth, may have given rise once more to sharp increases in average cross-border deal values.

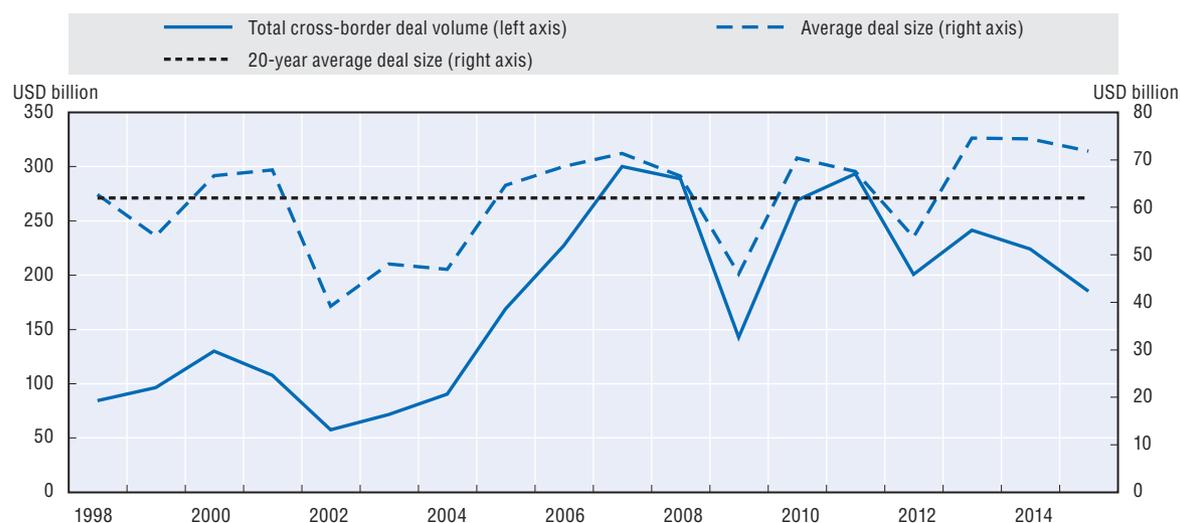
Figure 2.11. **Average global cross-border deal sizes**

Source: Dealogic (2015b), M&A Analytics (database), www.dealogic.com/investment-banking/ma-analytics.

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Since 2012, the value of the average cross-border merger and acquisition deal has risen from USD 75 million to USD 117 million, an increase of 57%. In the lead-up to both of the previous global crashes, when average cross-border deal values exceeded their 20-year average value for two consecutive years, there was a sharp fall in cross-border merger and acquisitions (and global foreign direct investment flows). The same pattern can be observed in developing and emerging markets, with above-average deal values being consistently followed by declines in cross-border mergers and acquisitions and in foreign direct investment on four occasions: in 2000/01, 2006/07, 2010/11 and 2013/14. In 2014, average deal values in the emerging markets were at 20-year record high levels and, consistent with past trends, cross-border investment began to decline in 2015 (Figure 2.12).

Figure 2.12. **Average cross-border merger and acquisition deal sizes in developing countries**



Source: Dealogic (2015b), M&A Analytics (database), www.dealogic.com/investment-banking/ma-analytics.

StatLink  <http://dx.doi.org/10.1787/888933357668>

What are the policy implications of a slowdown in foreign direct investment?

While developing and emerging markets have experienced spectacular increases in international investment flows over the course of the past decade, there are important warning signs that their inward investment flows could undergo a sharp slowdown over the coming years (or even reverse in some cases). This would have important ramifications for both the emerging markets and for international investment markets.

First, while the volatility of foreign direct investment flows in recent years has not given rise to a significant increase in investment protectionism, a major slowdown could, nonetheless, motivate the emerging markets to take more cautious and less-welcoming approaches towards foreign investors and, more generally, foreign capital. We see signs of this, for example, in the growing use of foreign currency-based restrictions in financial sectors, as well as in the growing scepticism regarding certain elements of the international investment treaty system, such as investor-state dispute settlement.

Second, if international investment flows to the developing and emerging markets do experience significant declines, or even reversals, this could undermine political support for the structural reform agenda that underpinned increasing flows of investment to those markets in the first place, but which remains far from completed (see the “In my view” box by Shaun Donnelly later in this chapter).

Third, although it is unclear to what extent increased volatility in foreign direct investment flows might affect global value chains, there are likely to be implications (Box 2.1). Since multinational enterprises play a central role in the governance of global value chains and international production

In my view: Pro-investment policies really matter!

Shaun Donnelly,

Vice President, Investment and Financial Services,
United States Council for International Business

Businesses – whether large or small, based in OECD nations or in emerging and developing countries – all realise that investing globally is critical for growth, competitiveness and even survival in a globalised economy. Today’s foreign direct investment flows take on many forms and touch every sector of the economy, with trends and patterns that are far different from those of only a decade or so ago. Foreign direct investment is no longer one way, from the developed “North” to the developing “South”. Countries like China, India and other emerging markets are major investors, and foreign direct investment offers “win-win” opportunities that can benefit the economies of both investor and host nations.

In my view, and more importantly listening to business leaders around the world, foreign direct investment flows into developing countries will continue to grow over the long term. For many years we will likely see these flows grow by double digits. But there will be ups and downs, and the competition will be strong. Firms, whether in OECD countries or emerging/developing economies, will make their investment decisions based on careful assessment of market opportunities, prospects of return on investment and risks. They will be deciding where to invest based on the presence – or absence – of some key characteristics in the host “investment climate”:

- rule-of-law, independent judiciary and respect for private property, including intellectual property
- pro-business trade and tax regulatory frameworks at the federal and sub-federal levels
- incentive packages at the national and local levels
- strong anti-bribery and anti-corruption legislation, regulations and enforcement
- strong legal protection for investors, including through bilateral and other international investment agreements
- solid infrastructure, including information and communications technology and transportation
- links to global supply chains
- the presence of local/regional markets for the goods produced by the investment
- a skilled local workforce
- appropriate human rights, labour rights and environmental regulations
- access to natural resources.

All these factors come together to create an enabling investment climate in the individual country. The OECD, along with the World Bank, USAID and other organisations, has done path-breaking work to produce guidance on improving investment climates. In particular, the OECD’s just-updated *Policy Framework for Investment* (OECD, 2015a; see “The way forward for foreign direct investment”; and Chapter 6) provides a clear and comprehensive checklist for all developing nations that are serious about improving their investment competitiveness.

Individual investors will, of course, continue to assess investment climates and weigh key factors in their own unique way. But in general, the message I’m hearing from major investors is that the quality of investment opportunities is increasingly important. It is not just a matter of choosing the lowest cost or the largest market. Investors want to invest not just in good projects, but also with “good” partners in “good” countries with “good” policies.

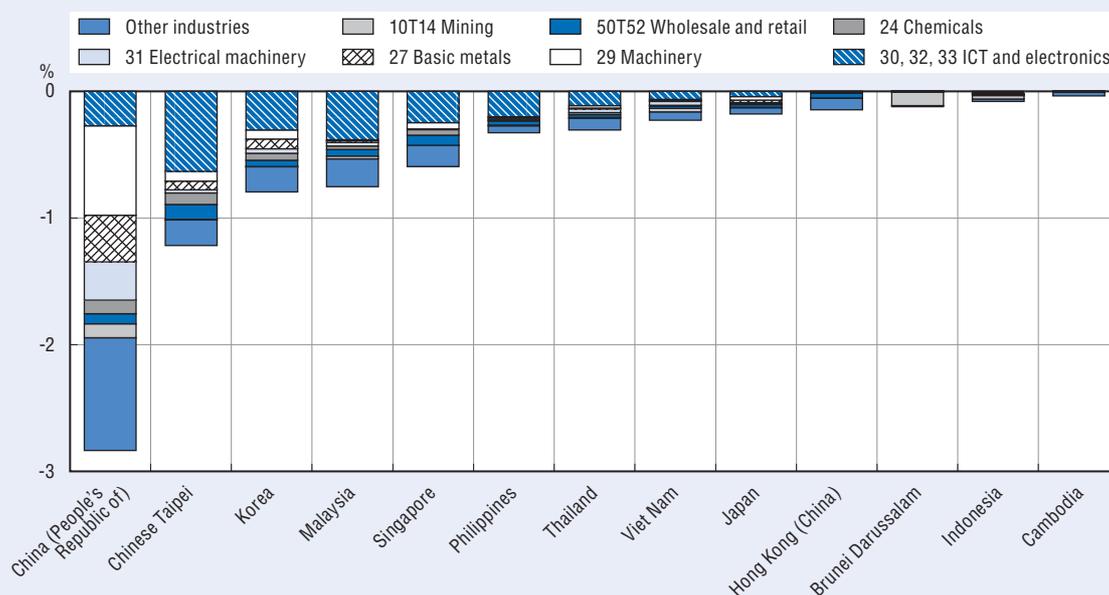
Box 2.1. The impact of decreasing investment on regional value chains

A joint undertaking by the OECD and the World Trade Organization, the Trade in Value Added (TiVA) initiative is designed to inform policy makers by providing insights into the commercial relations between nations.¹ It does so by considering the value added by each country in the production of goods and services that are consumed worldwide. TiVA indicators, and their underlying Inter-Country Input-Output data system (ICIO), differentiate among 34 industrial activities² in 61 countries.³

Foreign direct investment can be used to purchase capital goods, such as machinery and equipment, and also for the acquisition of existing facilities. As such, some part of foreign direct investment usually contributes to gross fixed capital formation (i.e. investment in productive assets), although the relative size of this contribution can vary significantly from country to country. Efforts to understand the links between foreign direct investment and trade in value added are ongoing (for example, see OECD, 2015b).

Nonetheless, a look at gross fixed capital formation can yield some insights into how changes in one country's investment patterns can affect industries in other countries. For instance, Figure 2.13 shows how a 10% decrease in Chinese gross fixed capital formation in machinery and equipment would have affected value added in selected East and Southeast Asian economies in 2011, the most recent year for which ICIO data are available. The effect on total value added differs, with Chinese Taipei's value added decreasing by more than 1% and Cambodia's, Indonesia's and Brunei Darussalam's value added being hardly affected. The figure focuses on the seven industries that would have been affected the most. Although the relative impact on the various industries differs largely across countries, within China the machinery industry would have been the most severely affected. In the rest of the region, information and communications technology and electronics would have been the most affected, with basic metals being the third most affected industry across the board. The exception is Brunei Darussalam, where 95% of the loss of value added would have been in the mining sector.

Figure 2.13. **Loss of value added in East and Southeast Asia due to a 10% decrease in gross fixed capital formation for machinery and equipment in China**



Notes: The underlying data used for these calculations are the Inter-Country Input-Output data system (ICIO) for 2011, the most recent year available. The industry classifications come from the International Standard Industrial Classification of All Economic Activities (ISIC Rev. 3), with 10T14 representing industries 10 to 14 (see <http://unstats.un.org/unsd/statcom/doc02/isic.pdf>).

Source: OECD (2015d), "OECD Inter-Country Input-Output (ICIO) tables, Edition 2015: Access to data", <http://oe.cd/icio>.

StatLink <http://dx.doi.org/10.1787/888933357673>

1. For more information, see <http://oe.cd/tiva>.

2. See: www.oecd.org/sti/ind/tiva/TiVA_2015_Industry_List.pdf.

3. See: www.oecd.org/sti/ind/ICIO2015_Countries_Regions.pdf.

Source: OECD (2015c), "Measuring trade in value added: An OECD-WTO joint initiative", webpage, OECD, Paris, www.oecd.org/sti/ind/measuringtradeinvalue-addedanoecd-wtojointinitiative.htm (accessed 21 January 2016).

networks, a pullback from developing and emerging markets might have implications beyond the first-order welfare implications of the investment declines themselves. The complex dynamics underpinning the relationships between international investment and global value chains might render the rebuilding of these systems more challenging than simply attracting investment once more. The role of international investment in shaping global value chains, and the ways in which these in turn contribute to development, are the subject of continuing analysis by the OECD.

On the other hand, the surprising speed with which the global distribution of foreign direct investment shifted during the 2008 crisis suggests that a reversal could be just as swift. It also suggests that foreign direct investment may no longer be quite as stable a form of cross-border investment as it once was. For developing and emerging markets, which have become ever more reliant on foreign direct investment to support their development objectives, the trends of the past decade highlight important policy challenges.

The way forward for foreign direct investment

Key among these challenges is the need for developing countries and providers of development assistance to frame development strategies around the complementary and mutually reinforcing roles of private investment and official development assistance (see Chapters 1 and 3). Private investment will always follow cycles and, as we have seen in recent years, is also subject to structural shifts as multinational enterprises change both the location of their international production networks and the way they organise them. As more developing and least developed economies connect to global value chains through investment and trade, they will gain exposure to both the opportunities and the risks that these changes bring. Among the opportunities, these economies will benefit from greater access to international markets, technological upgrading and human resource development. Among the risks, there will be increased exposure to the sort of turbulence and sharp shifts observed in public-private investments, global project financing (which underpins much greenfield investment, through which the foreign investor constructs new operational facilities in the host country from the ground up) and cross-border mergers and acquisitions.

All of this serves as a reminder of how important it is for the development co-operation and investment policy communities to continue to work closely together (see the “In my view” box by James Zhan).

At the outset of this chapter, Karl P. Sauvant poses three challenges for foreign direct investment: increasing the quantity of this investment; improving foreign direct investment to ensure that it is geared as closely as possible towards sustainable development; and reforming international investment law and policy to create an enabling framework that encourages sustainable foreign direct investment while allowing governments to pursue their legitimate public policy objectives.

The OECD’s *Policy Framework for Investment* can help to address all three of these challenges (OECD, 2015a; see also Chapter 6). Designed to help countries improve their business climate, it looks at the investment climate from a broad perspective. Not only does it aim to increase investment, but also to maximise its economic and social returns – in other words, to make the quality of investment as important as the quantity. The framework also recognises that a good investment climate is good for all firms – foreign and domestic, large and small.

In my view: A new generation of policies can create a “big push” for private investment in sustainable development

James Zhan,

Director of Investment and Enterprise at the United Nations Conference on Trade and Development, and Editor-in-Chief of the United Nations *World Investment Report*

Achieving the Sustainable Development Goals (SDGs) calls for concerted efforts to galvanise private sector investment in numerous SDG-linked sectors: infrastructure development, health and education, agriculture and food security, and a host of other areas of social, environmental and economic challenges.

In my view, building an effective compact between the public and private sectors to mobilise and channel investment towards the SDGs will demand transformative action over a broad range of areas. The United Nations Conference on Trade and Development’s (UNCTAD) action plan for private investment in the SDGs (UNCTAD, 2014) puts forward policy options in the form of focused action packages in specific segments of SDG investment, designed to promote a “big push” by the international community and national policy makers for private investment in sustainable development:

- **Establishing investment agencies** specialised in creating and marketing pipelines of bankable projects in SDG sectors, bringing together specialist expertise propped up by technical assistance. Regional investment “brokers” could help lower costs and create economies of scale. The promotion of investment in SDG sectors should be supported by an international investment policy regime that pursues the same objectives. Currently, international investment agreements (IIAs) focus solely on investment protection. A new generation of IIAs should safeguard policy space for sustainable development.
- **Restructuring investment schemes** to create incentives that facilitate sustainable development projects. This could also help to mobilise finance for the SDGs. “Location-based” incentives – targeted at increasing local competitiveness – could be replaced by “SDG-based” incentives, targeted at promoting investment for sustainable development.
- **Using regional and South-South investment compacts** to inject impetus into SDG investment, especially for cross-border infrastructure development and regional clusters of firms operating in SDG sectors (e.g. “green zones”). These compacts could include joint investment promotion mechanisms, programmes to build absorptive capacity and public-private partnerships.
- **Forming new types of partnerships** between outward investment agencies in advanced countries and investment promotion agencies in developing countries to help to market SDG investment opportunities while facilitating joint monitoring and impact assessment. Concrete tools to support such efforts could include online pipelines of bankable projects and databases of opportunities for business linkages in developing countries. A multilateral technical assistance consortium could be set up to support the least developed countries.
- **Enabling innovative financing mechanisms and reorienting financial markets to advance sustainability.** New and existing financing mechanisms, such as green bonds and impact investing, deserve support and an enabling environment to allow them to be scaled up and marketed to the most promising sources of capital. Furthermore, integrated reporting – on the economic, social and environmental impact of private investment – is needed to nudge financial markets towards sustainable development requirements. This is a fundamental step towards responsible investor behaviour.
- **Establishing a curriculum for business schools worldwide** to change the business mindset and raise awareness about investment needs and opportunities in low-income countries. It should teach students the skills needed to successfully operate in developing country environments and encourage investment in, for and with the poor. Teaching materials could include relevant modules in training and certification programmes for financial market actors.

The 2030 Agenda for Sustainable Development (UN, 2015) is without doubt the most ambitious development plan yet to be embarked upon by the international community. Only by pooling global resources and ideas in a concerted manner will we ensure efforts to put the world on a more sustainable growth path.

So how does it work? The *Policy Framework for Investment* looks at 12 areas affecting investment:

1. investment policy
2. investment promotion
3. investment facilitation
4. competition
5. trade
6. taxation
7. corporate governance
8. finance
9. infrastructure
10. policies to promote responsible business conduct
11. investment in support of green growth
12. public governance.

These policy areas affect the investment climate in diverse ways, influencing the risks, returns and costs for investors. While the framework looks at policies from an investor perspective, it aims to maximise the development impact of investment and not simply to raise corporate profitability.

The *Policy Framework for Investment* has been used to conduct OECD Investment Policy Reviews in over 25 developing countries.⁴ The framework is freely available and hence any country can undertake its own self-assessment, but in practice the combination of self-assessment and external assessment by the OECD has proved to be the best formula. The framework can also be used to help providers of development co-operation contribute to capacity development and private sector development, or to promote dialogue at the regional level.

The revised framework, launched in 2015, has a heightened focus on small and medium enterprises, and on the role played by global value chains. It has incorporated gender issues, a vital element of inclusive development, and has a chapter on policies to channel investment in areas that promote green growth. To address issues of how to move from assessments to actual implementation of reforms on the ground, the development co-operation community has been strongly involved in discussions surrounding the update (see, for example, Thomsen, 2015).

Key messages on foreign direct investment

- While foreign direct investment in developing and emerging markets is expected to follow an overall increasing trend over the long term, in the immediate future it could experience a sharp slowdown, with important ramifications for both the emerging markets and for international investment markets in general.
- Developing and emerging markets may begin to take a more cautious, protectionist approach towards foreign capital.
- The decline in public-private partnerships in developing countries, as well as in project financing in the least developed countries, are important warning signals given the particular needs of these countries for development assistance, especially for infrastructure.
- A slowdown could undermine political support for the still uncompleted structural reform agenda that has underpinned increasing flows of investment to emerging markets.
- Given the complex dynamics underpinning the relationships between international investment and global value chains, the effects of a slowdown on these value chains – and on development in general – are difficult to determine.

- A shift in overall trends in foreign direct investment – from relative stability to increasing fluctuation – would have important policy implications for the developing and emerging markets, which are increasingly reliant on foreign direct investment to support their development objectives.
- Developing countries and providers of development assistance can address the cyclic, changing nature of foreign direct investment trends by framing development strategies around the complementary and mutually reinforcing roles of private investment and official development assistance.

Notes

1. Argentina, Brazil, the People's Republic of China, India, Indonesia, Mexico, the Russian Federation, Saudi Arabia and South Africa.
2. Although there is no precise definition for what constitutes “project financing”, usually this takes the form of investments either in infrastructure or extractive industries.
3. This finding runs counter to the traditionally-held view that cross-border mergers and acquisitions are limited to the developed economies.
4. See: www.oecd.org/investment/countryreviews.htm.

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