UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

UNCTAD Series
on issues in international investment agreements

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NOTE

UNCTAD serves as the focal point within the United Nations Secretariat for all matters related to foreign direct investment and transnational corporations. In the past, the Programme on Transnational Corporations was carried out by the United Nations Centre on Transnational Corporations (1975-1992) and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development (1992-1993). In 1993, the Programme was transferred to the United Nations Conference on Trade and Development. UNCTAD seeks to further the understanding of the nature of transnational corporations and their contribution to development and to create an enabling environment for international investment and enterprise development. UNCTAD's work is carried out through intergovernmental deliberations, research and analysis, technical assistance activities, seminars, workshops and conferences.

The term "country" as used in this study also refers, as appropriate, to territories or areas; the designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. In addition, the designations of country groups are intended solely for statistical or analytical convenience and do not necessarily express a judgement about the stage of development reached by a particular country or area in the development process.

The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

A blank in a table indicates that the item is not applicable;

A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

Use of a hyphen (-) between dates representing years, e.g. 1994-1995, signifies the full period involved, including the beginning and end years.

Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

Annual rates of growth or change, unless otherwise stated, refer to annual compound rates.

Details and percentages in tables do not necessarily add to totals because of rounding.

The material contained in this study may be freely quoted with appropriate acknowledgement.

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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view towards assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups of civil society and the preparation of a series of issues papers.

This paper is part of this series. It is addressed to government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant and Pedro Roffe, and including Victoria Aranda, Anna Joubin-Bret, John Gara, Assad Omer, Jörg Weber and Ruvan de Alwis, under the overall direction of Lynn K. Mytelka; its principal advisors are Arghyrios A. Fatouros, Thomas L. Brewer and Sanjaya Lall. The present paper benefitted from inputs by Manuel R. Agosin. It also reflects comments received from John H. Dunning, Persa Economou, Dieter Ernst, Fabio Fiallo, Padma Mallampally and Zbigniew Zimny. The production of the paper was carried out by Hélène Dufays. It was desktop published by Teresita Sabico.

Funds for UNCTAD's work programme on a possible multilateral framework on investment have so far been received from Australia, Brazil, Canada, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as India, Morocco and Peru have also contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.

R Ricupero

Rubens Ricupero
Secretary-General of UNCTAD

Geneva, December 1998

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Executive summary

This paper considers the role of foreign direct investment (FDI) in development. It is meant to give an overview in respect of this topic. At the same time, it provides the broader economic underpinnings for the specific issues relating to international discussions or negotiations on investment which are addressed in other papers of the series.

The paper starts with a discussion of the effects of FDI on development through trade, one third of which takes place within corporate production systems. The reason for starting with the trade effects of FDI are twofold. *Primo*, trade has traditionally been the principal mechanism linking national economies. FDI does have a similar linking function and, therefore, it is interesting to ascertain whether, and to what extent, the two linking functions reinforce each other. *Secundo*, and perhaps more importantly, the close, and growing, interrelationship that exists between trade and investment implies that trade policy issues and investment policy issues increasingly cannot be adequately addressed in isolation from one another. Further progress in the field of trade liberalization, therefore, is likely to necessitate an in-depth assessment of the trade implications of investment; and, conversely, effective action on FDI issues cannot be carried out without paying due attention to the interconnections that exist between trade and investment.

The trade effects of FDI depend on whether it is undertaken to gain access to natural resources or to consumer markets, or whether FDI is aimed at exploiting locational comparative advantage and/or other strategic assets such as research-and-development capabilities. Such trade effects are the result of the package of tangible and intangible assets that transnational corporations (TNCs) can bring to a host country through FDI or such other relationships as subcontracting, and which, in an increasingly liberalizing and globalizing world economy, acquire considerable importance, particularly as regards developing countries, for competing successfully in world markets.

The impact of FDI on development goes well beyond its linkages with trade. By its very nature, FDI brings into the recipient economy resources that are only imperfectly tradable on markets, especially technology, management know-how, skilled labour, access to international production networks, access to major markets and established brand names. These assets can play an important role in the modernization of the national economy and in the acceleration of economic growth. In addition, FDI can make a contribution to growth in a more traditional manner, by raising the investment rate and expanding the stock of capital in the host economy.

It has thus been widely recognized by governments -- as reflected in paragraph 36 of "A Partnership for Growth and Development" adopted by UNCTAD IX in 1996 -- that "foreign direct investment (FDI) can play a key role in the economic growth and development process. The importance of FDI for development has dramatically increased in recent years. FDI is now considered to be an instrument through which economies are being integrated at the level of production into the globalizing world economy by bringing a package of assets, including capital, technology, managerial capacities and skills, and access to foreign markets. It also stimulates technological capacity-building for production, innovation and entrepreneurship within the larger domestic economy through catalysing backward and forward linkages" (UNCTAD, 1996a).

There are areas, however, in which the impact of FDI can be negative, e.g. in cases where competition is stifled, restrictive business practices are used or transfer prices are manipulated. Small economies, furthermore, may need to guard against too much FDI too quickly: flows of FDI that are too large for the absorptive capacity of the host economy are likely to bring about negative side effects such as the appreciation of the exchange rate, which in turn has a negative impact both on export development and import substitution. The impact can also be suboptimal; this