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MULTILATERAL MEASURES TO PROMOTE FOREIGN DIRECT INVESTMENT

**Contribution by the United Nations Industrial
Development Organization (UNIDO)***

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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION

UNIDO Initiatives to Promote Non-
debt-creating Financial Flows to
Developing Countries, with Particular
Reference to Foreign Direct Investment

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Abstract

The present paper summarizes for the Members of the Ad hoc Working Group on Investment and Financial flows UNIDO work on the promotion of FDI in developing countries. Since these activities form only one component of UNIDO's overall programme of work on mobilizing investment financial flows to the developing countries, the document also presents a short UNIDO response to issues in this more general area raised at the second session of the Working Group.

Global FDI flows

Research carried out by UNIDO shows that many developing and Eastern European countries are competing for FDI as a means of entering a global economy characterized by an increasingly integrated world production, trading, and investment system. FDI have at the same time become more concentrated on a small number of developed countries as sources of investment, and France, Germany, Japan, the United Kingdom, and the United States of America are providing the vast bulk of FDI inflows. Factors responsible for the concentration in those countries included: corporate strategies to redeploy production behind protection barriers; increased intra-industry cooperation, particularly in high technology areas; and the creation of the unified market of the European Community.

The share of developing countries in world FDI inflow declined from about 38 per cent in 1981 to 10 per cent in 1988, but there has been a vigorous upturn in 1992 and 1993, with large new FDI flows into parts of Latin America and into China. In 1971, 20 developing countries accounted for almost two thirds of the total stock of FDI, with this share increasing to three quarters in 1978. Currently, just 18 countries and territories are attracting 86 per cent of FDI flows to the developing world, with Argentina, Brazil, Mexico, Venezuela, China, Taiwan (Province of China), Indonesia, Malaysia, Republic of Korea and Thailand being the largest recipients in 1992. FDI inflows in value terms have grown from US\$40 in 1992. The position of the least developed countries has regrettably further deteriorated.

There are no aggregate data on the industrial branch composition of FDI in the developing countries, but case studies tentatively suggest that chemicals, electronics, clothing and food processing have been favoured. A trend is, however, emerging for FDI to spread to transport equipment, electrical machinery, machine tools and other engineering products.

In general, FDI flows are sensitive to economic conditions and policies in recipient countries such as macro-economic management (especially of external debt, but also of internal inflation and the exchange rate); other economic policies (price controls, taxes, attitudes to the private sector, labour laws and conditions, stability of incentives); political stability; and anticipated economic and export performance. FDI has increasingly gone to countries that have a stable, transparent and predictable environment with good prospects for foreign investors to earn and repatriate returns and to integrate the new locations into their global strategy.

The increasing role of small- and medium-size enterprises in FDI flows is another notable trend and those enterprises have now firmly begun to enter the international market. In supplying components and parts to large enterprises, the small- and medium-size enterprises follow their clients abroad and become internationalized themselves. Moreover, technological innovations have led to a new "techno-economic paradigm", affecting not just technologies or organizational structures in a narrow sense, but involving virtually the creation of a new business culture. The changes most relevant for FDI patterns are: reductions in production costs, particularly in the labour components of costs; new forms of organization at the firm and plant level; new patterns of sourcing for components and services, with proximity, flexibility and speed of response becoming of dominant importance, and new profiles of labour skills.

To attract small- and medium-size enterprises from developed and more industrialized developing countries imperfections in information, skill and insurance markets must be overcome. Small- and medium-size enterprises tend to be much less familiar with operating conditions, both economic and political, in foreign countries than large firms and tend to be less tolerant of unfamiliar bureaucracies and legal requirements. It is harder for them to spare or to recruit the high-level manpower needed for success. Finally, they are more risk-averse than large firms because of the higher potential cost of failure.

The most important conclusion is that for those developing countries which are determined to use FDI as an important element in their industrial development strategy, it is essential to provide the conditions and the institutions which nurture domestic entrepreneurs, and which foster the growth of a creative business culture. Without a dynamic domestic business community engaged in industry, the benefits of foreign investment may not be obtained. Joint ventures depend upon attractive domestic partners. Domestic small-scale companies act as important suppliers of specialized inputs which are an additional incentive to foreign companies. Most importantly, domestic entrepreneurs can capture significant "externalities", i.e. they can learn and gain invaluable experience on industrial and commercial matters from foreign business partners and competitors, and so contribute to overall industrial development.

EPZs

With the increasing globalization of manufacturing and trade, there has been a growing interest in export processing zones (EPZs) as a mechanism for fostering FDI flows. Considering the large number of free zones/export processing zones around the world, only some have been successful. Many lack a suitable investment climate, experience difficulties in operating under complex laws and regulations or face problems of management, inappropriate locations or high costs. Taking into consideration that the net FDI flows to developing countries, particularly in the case of the least developed countries, have been growing at a much lower rate than the flows to developed countries, EPZs are increasingly competing to attract investors to their location.

Based on lessons learnt throughout the world, EPZs are by no means to be considered a 'magic tool' for economic development. The EPZ concept is one of the instruments on the menu of investment and export promotion policies aimed at creating immediate benefits in terms of employment, foreign exchange earnings, etc.

Therefore, if governments opt for an EPZ programme, this is in UNIDO's view only to be seen as part of overall economic and industrial policies and strategies for the country. To attract domestic and foreign firms that manufacture for exports and can compete on international markets, the overall business environment has to be conducive in terms of fostering private sector development.

Governments use the EPZ tool to attract investors by offering, at least as a transitional measure and as part of broader economy-side reform efforts, a liberalized environment, free trade conditions and infrastructural facilities. In this respect, EPZs have proven a valuable catalyst for economic reforms too radical for immediate nation-wide adoption in a number of countries.

UNIDO always stresses that governments should carefully study the viability of the EPZ tool before engaging in an EPZ programme. EPZ incentives exist to supplement the basic preconditions which must be in place for giving a particular location or country a competitive edge which determines the success of the EPZ tool. These basic conditions are particularly political stability, a realistic exchange rate, clear and simple legislation setting out the ground rules for the investor (minimum bureaucracy), a legal and regulatory environment favourable to private sector development (e.g. efficient customs administration), good physical infrastructure, efficient basic support services, access to markets through tariff preferences and other trade advantages, availability of skilled labour, and efficient EPZ management.

As regards the linkages with the rest of the economy, except for the newly industrialized countries and a few developing countries, significant linkages have hardly been developed. Although linkages should be encouraged, in UNIDO's view market forces will ultimately dictate the pace of linkage development. Foreign investors will be willing to source materials and services locally, if their prices are competitive and supply is regular

quantitatively and qualitatively. Therefore, governments have a role to play to help create a strong indigenous industrial base with a view to attracting investment that creates employment and involves transfer of more advanced technologies, especially since long-term prospects for EPZ development based only on low-cost labour are not very good.

On the issue of the appropriate public/private mix, it is to be noted that the private sector has a good track record in EPZ development in a number of countries and is expected to become more active in zone development and management. In case of public EPZ authorities, the board should include a strong representation of the private sector. While most EPZs have public sector management, the successful ones operate in a business-like manner.

UNIDO's technical cooperation activities in the field of EPZ, which include advisory services and training in the development, management and promotion of EPZs, are demand-driven. UNIDO generally intervenes at four levels:

- 1) preliminary investigations into the viability of the EPZ tool (pre-feasibility studies);
- 2) feasibility studies on EPZs including identification of potential investors, drafting of legislation, organizational structure, physical planning, financial and economic analysis, identification of promotion methods;
- 3) assistance in the establishment of EPZs; and
- 4) assistance in the marketing and promotion of EPZs (investment promotion).

UNIDO Industrial Investment Programme

The Development Committee of the World Bank and the IMF issued a communique in May 1993 which included the following paragraph: "The committee believes that FDI is the most valuable form of private external finance. It also calls on the industrial countries and the international institutions to play their part by providing technical assistance, investment sector lending, fuller information, guarantees and where appropriate financial support". UNIDO is probably the first international institution to extend technical assistance to entrepreneurs in developing countries to facilitate the conclusion of business-oriented industrial investment ventures between entrepreneurs in developing countries and their counterparts in industrial and more advanced developing countries. Already in 1969, a UNIDO publication stated that "it has been widely acknowledged that to accelerate the rate of industrial development in developing countries, an ever increasing flow of domestic and external resources in their industries is required. However, the fact is that the current flow of resources into industry is inadequate compared to the needs. Therefore, the need of the day is to devise a new set-up or improve upon the existing set-up, which will enable developing countries to mobilize more effectively external and domestic resources for their industrial development.

To assist developing countries in their search for more effective mobilization of external and domestic resources, UNIDO has inaugurated a programme called the 'Industrial Investment Promotion Programme' under which UNIDO assistance to developing countries is provided in:

- Promotion of the flow of external resources in specific industrial projects;
- Establishing new investment promotion machinery or improving the operations of existing machinery;
- Training their nationals in techniques of investment promotion;
- Securing the services of expert advisers.

UNIDO's Programmes provides integrated technical assistance to developing countries and economies in transition, upon their request. This integrated assistance is usually designed specifically for each requesting country on the basis of a prior diagnosis, undertaken by UNIDO experts, of major problem areas in the country concerned with the aim of identifying technical assistance needs at three levels:

- (i) policies for the creation of an enabling environment for domestic investors and improvement of the investment climate for foreign investors;
- (ii) institutional infrastructure for the promotion of the country as an attractive place to invest and the promotion of specific investment projects; and
- (iii) private entrepreneurs, mostly small and medium size firms, considering or willing to consider investing either in a new industrial venture or in expanding or rehabilitating an existing undertaking.

The diagnosis of problem areas usually includes an analysis of the country's industrial policies and programmes, its investment climate, its projects identification and promotion institutional infrastructure, and its industrial investment promotion needs. The success of these programmes is directly linked to the number of investment projects whose promotion is successfully concluded. The implementation of these programs may be financed from a variety of sources such as UNDP, bilateral and other multilateral.

The main aim of the integrated assistance is to assist the enterprise sector in developing countries to mobilize the foreign investment resources required for the implementation of their new, expansion, modernization or rehabilitation investment projects. The foreign investment resources which UNIDO can assist in mobilizing include equity, loan or other forms of traditional and non-traditional financing, technical or management expertise, the supply of equipment or technology (licensing), training, market access, etc, as well as financial resources and/or expertise for preparing or completing the preparation of the required pre-investment studies. Entrepreneurs in developing countries are assisted in mobilizing these resources through international business oriented co-operation with foreign partners.

A typical integrated technical co-operation programme includes, in addition to specific investment projects identification, formulation and promotion, assistance in investment climate improvement, and strengthening of local institutions and national capabilities in industrial investment project identification, formulation and promotion. Foreign investment resources are mobilized for developing countries by assisting their entrepreneurs in the identification, formulation and promotion of specific, and potentially viable, investment projects which require foreign investment resources for their implementation.

Within UNIDO this assistance is provided by the Industrial Investment Programme, (IIP), which consists of the UNIDO Industrial Investment Division at UNIDO Headquarters in Vienna, the UNIDO network of Investment Promotion Service (IPS) Offices in Athens, Cologne, Milan, Paris, Seoul, Tokyo, Vienna, Warsaw, Washington D.C. and Zurich as well as the Industrial Co-operation Centres in Beijing and Moscow; and informal focal points in several UNIDO member countries.

As an aid to investment project identification and formulation in developing countries, the Industrial Investment Division (IID) has developed the "How to Start Manufacturing Industries" series of plants profiles, each of which lists the pre-requisites for a particular process: raw materials, machinery and equipment, labour, initial investment and some elements of production cost. To assist in the formulation and screening of investment promotion requires an analysis of their financial aspects, the Industrial Investment Programme (IIP) is using a simple application software package for testing purposes entitled PROPSIN ("Project Screening and Pre-appraisal Information System"). The Databank for Investment Promotion Programme (DIPP) is an integrated software package designed and copyrighted by UNIDO to automate the maintenance and use of information necessary for an investment promotion programme.

IID promotes investment projects, i.e. contacts potential foreign partners and endeavour to arouse their interest, through the ten UNIDO Investment Promotion Service (IPS) Offices and the two Industrial Co-operation Centres whose principal function is to identify foreign partners for the investment projects of investors from developing countries. The staff of the IPSS are in close touch with business communities and development agencies in their host countries and have established data banks with details of companies interested in industrial partnerships in developing countries, and of the type of opportunity they are seeking. The Delegates Programme implemented by the IPSS enables officials from investment promotion agencies, ministries of industry and other similar institutions in developing countries to participate in the day-to-day investment project promotion work of these offices and to develop direct contacts with host country industrialists, and with development and financing institutions. These delegates promote specific investment projects in their home countries and are also a valuable informal source of information on investment conditions in their home countries and the incentives offered to foreign investors.

The IIP has also developed a number of tools for bringing national investors into direct contact with potential foreign partners. The most important of these are:

(a) Investment Project Promotion Forums (Investment Forums) which are usually held in the developing countries to enable national investors and potential foreign partners to hold face-to-face bilateral discussions on specific investment projects previously identified and promoted by the IIP. Occasionally such forums are also held in industrialized countries in conjunction with specialized industrial fairs. The interaction, at the level of specific investment projects, between national investors from developing countries and potential foreign partners from industrial and other countries, often results in new project ideas being proposed to the national investors.

(b) Country Presentation Tours which are usually undertaken in the host countries of the IPSs, but may also be organized in other countries, for delegations from developing countries comprising senior government officials, executives of chambers of commerce and businessmen. The delegations call on potential foreign partners to provide them with information on investment conditions and opportunities in their home countries and to discuss specific investment opportunities.

The IIP also assists in the preparation of feasibility studies. These analyses are based on the internationally accepted UNIDO methodology for preparing industrial feasibility analyses. This is augmented by the UNIDO Computer Model for Feasibility Analysis and Reporting (COMFAR). This software is a more sophisticated and broader software tool than that used for screening, and covers economic as well as financial analysis.