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# Promise and Pitfalls of the WTO and FTAs: investment and trade in services

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# Key Messages

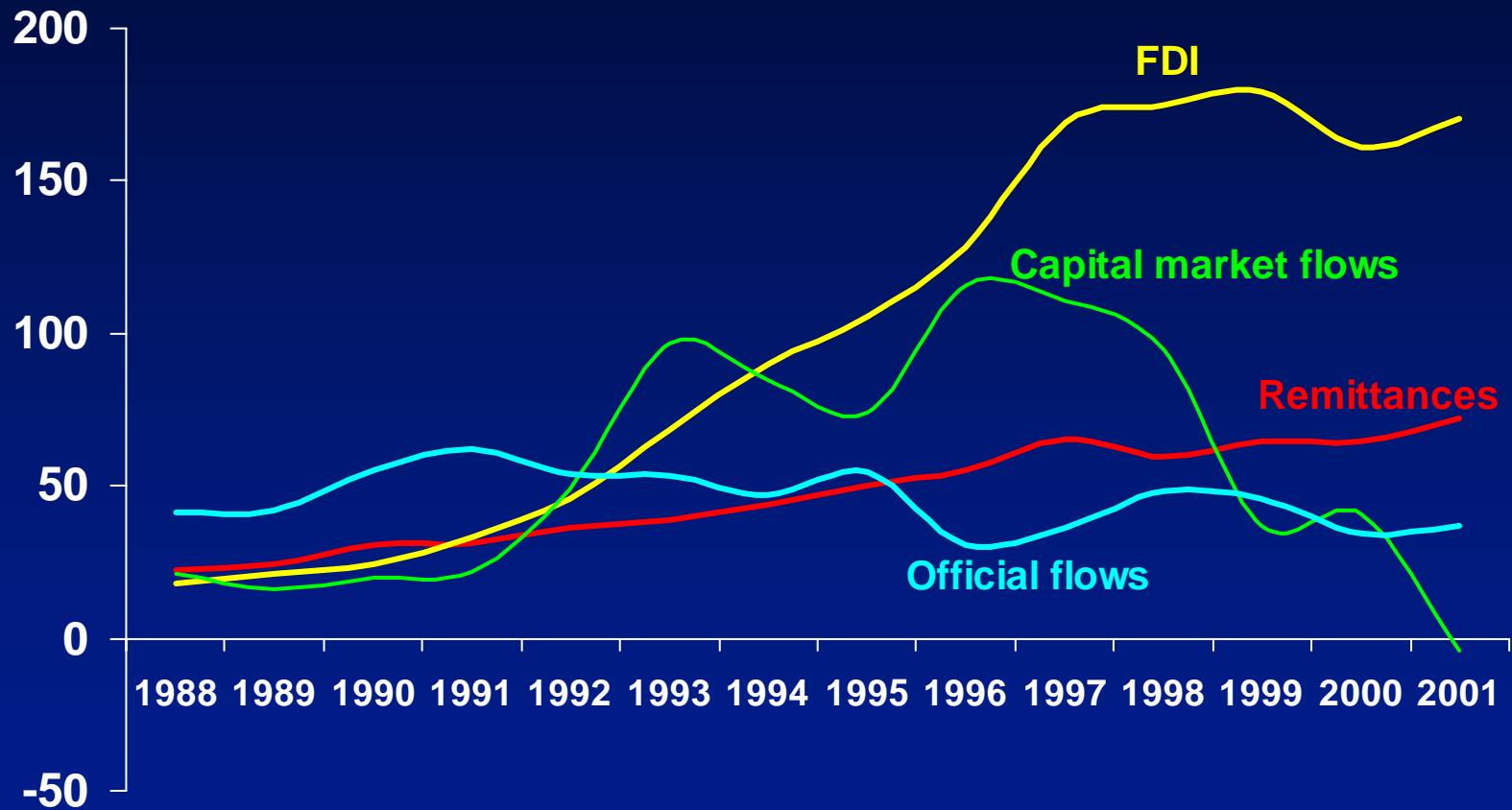
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- FDI to developing countries surged in 1990s and has evolved in terms of concentration levels, regional and sectoral distribution. Market-seeking has become the main motive of TNCs, reflecting the rise of services FDI and income growth in key emerging markets, e.g. China, India.
- High Income OECD countries are the main source of FDI in developing countries. However, the lion's share of their investment goes to other developed countries.
- FDI tends to promote growth by raising domestic investment and technology transfers.
- FDI has helped to create a significant amount of employment in developing countries, including in sectors characterized by high female employment.

# FDI has been a stable source of finance in developing countries

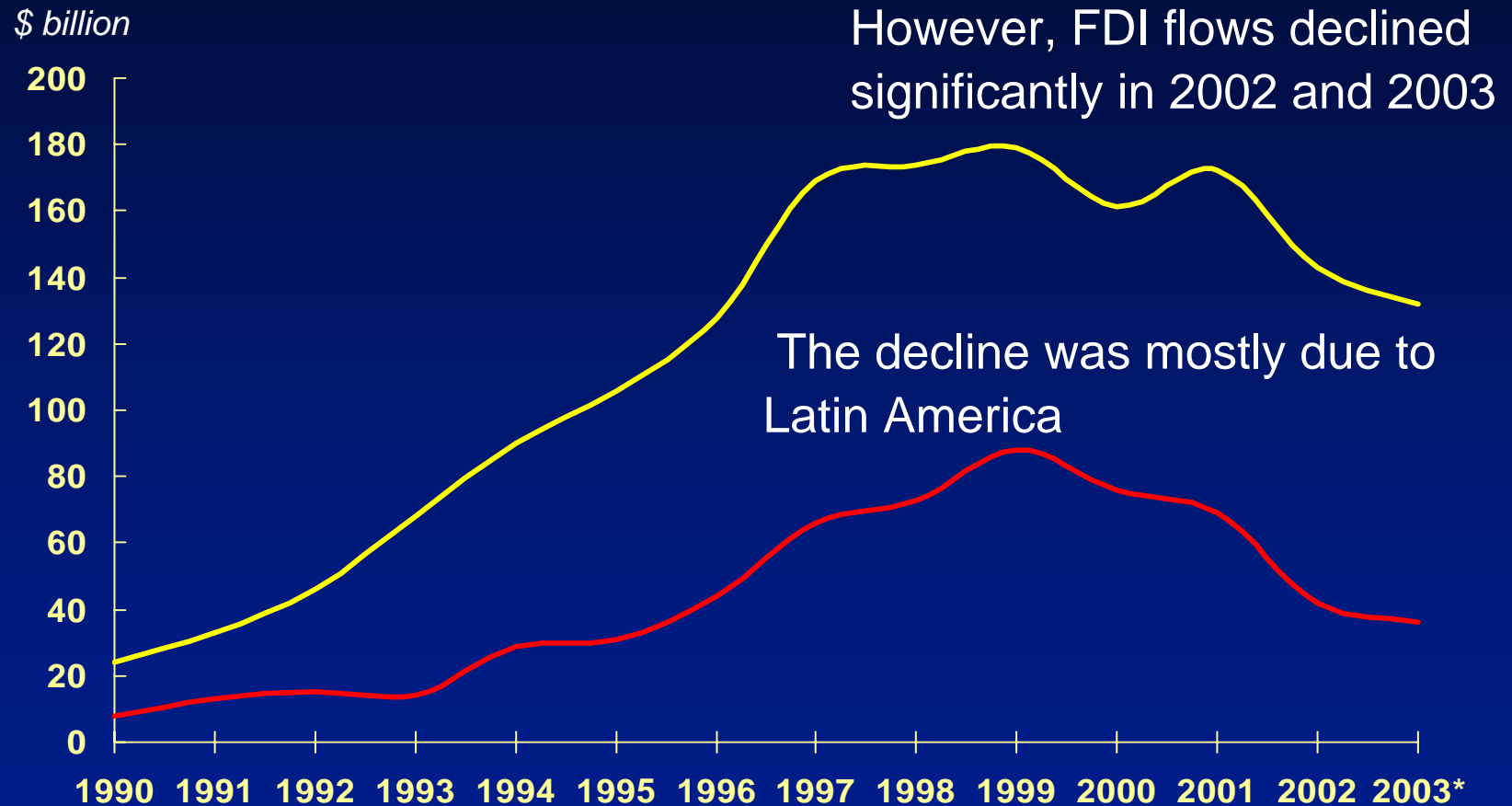
## Capital flows to developing countries

\$ billion



# FDI flows to developing countries surged in the 1990s...

## FDI flows



\* 2003 figures are World Bank staff estimates

# Factors that accounted for the decline in FDI

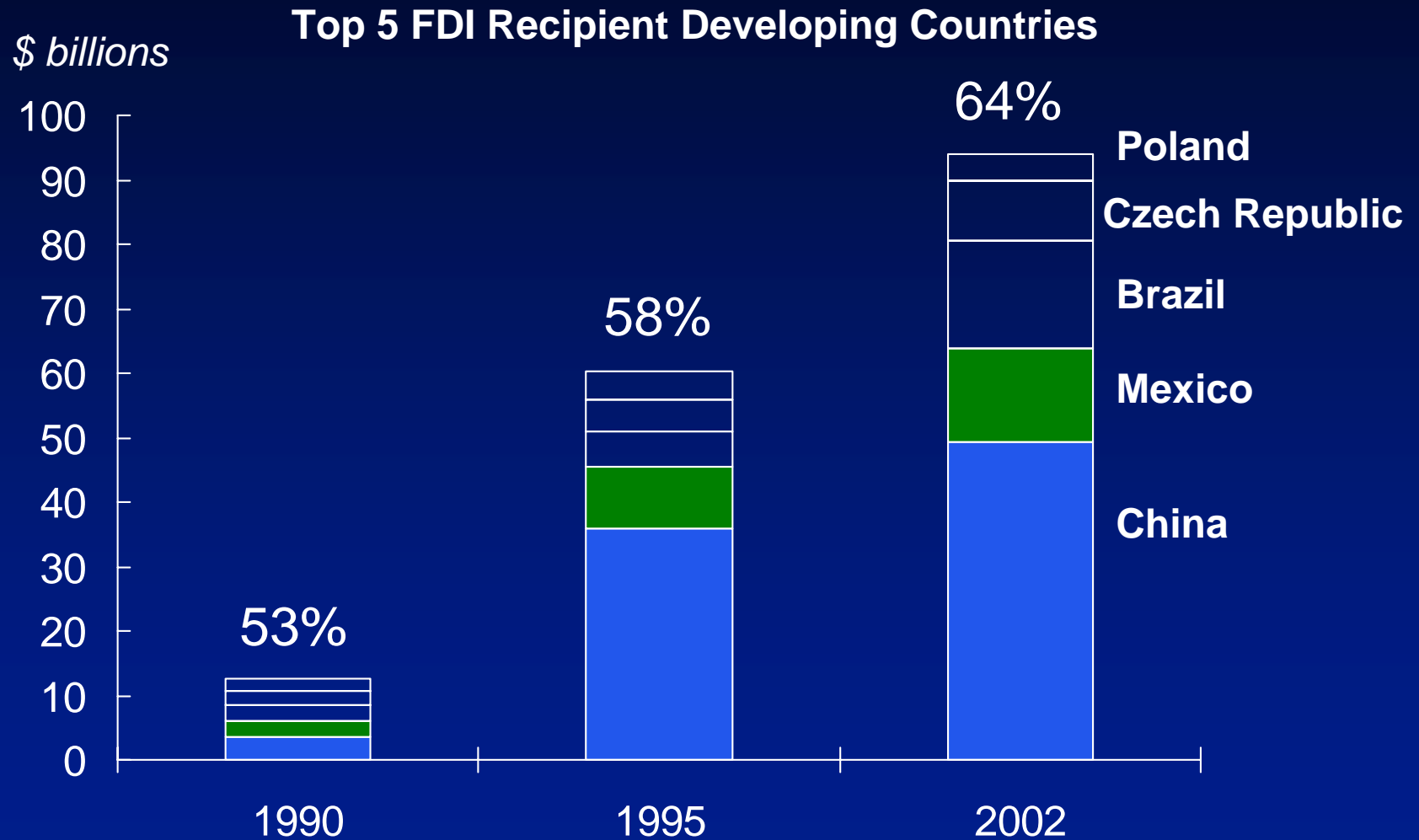
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- Slow growth both in developed and developing countries.
- Decline in stock market valuations (which led to the dramatic decline in cross-border M&As)
- The process of privatization is winding down
- Investors are concerned about the investment climate, availability of infrastructure, productivity of labor rather than low wages while investing in developing countries

# FDI flows to the Regions

<i>\$ billion</i>	2000	2001	2002	2003p
Total	162	175	147	133
East Asia & the Pacific	44	48	55	54
Europe & Central Asia	29	32	33	27
Latin America	77	70	45	36
Middle East & North Africa	2	6	3	2
South Asia	3	5	4	5
Sub-Saharan Africa	6	14	8	9

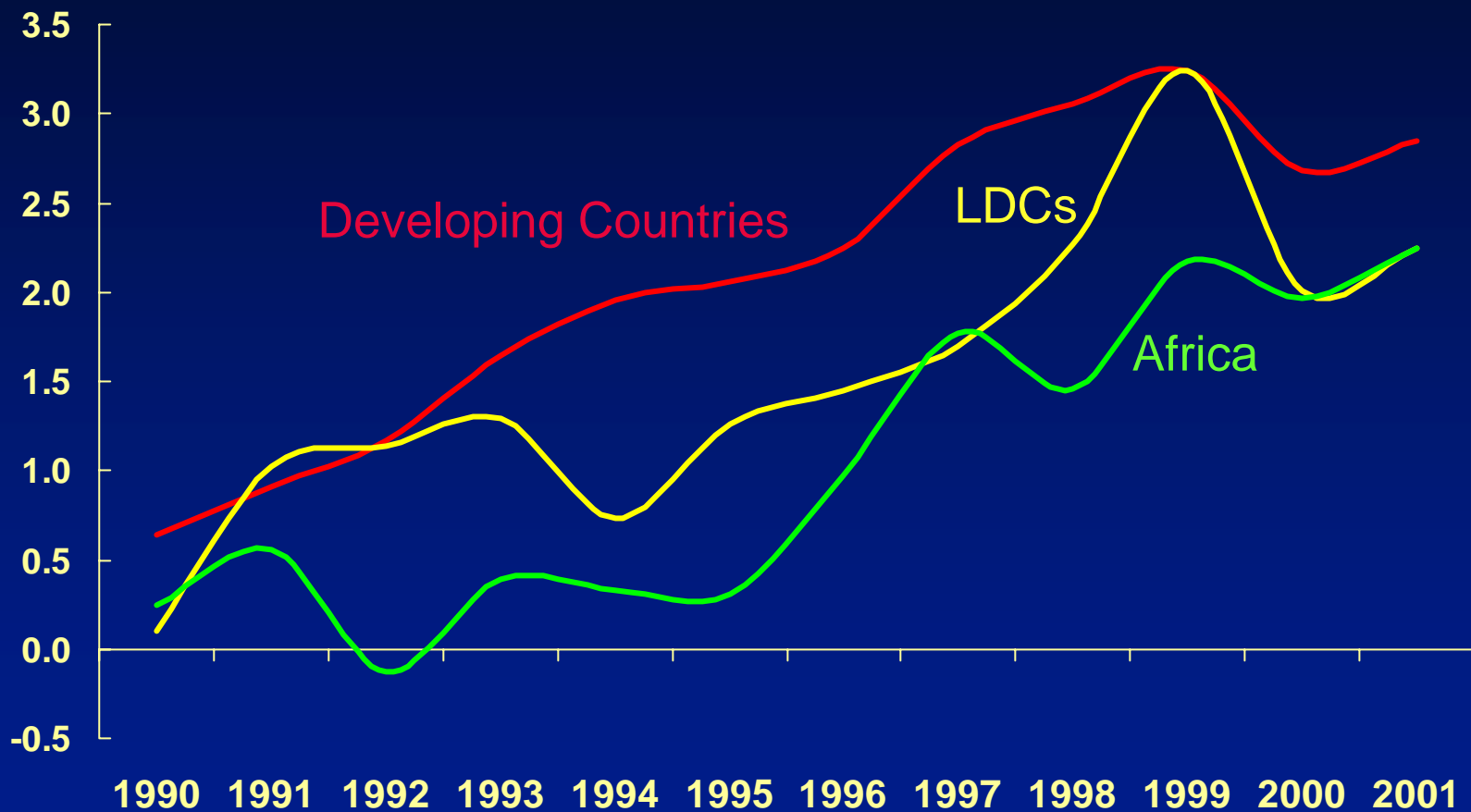
# Concentration of FDI increased over time



# Although FDI levels are low, FDI is significant for Poor Countries

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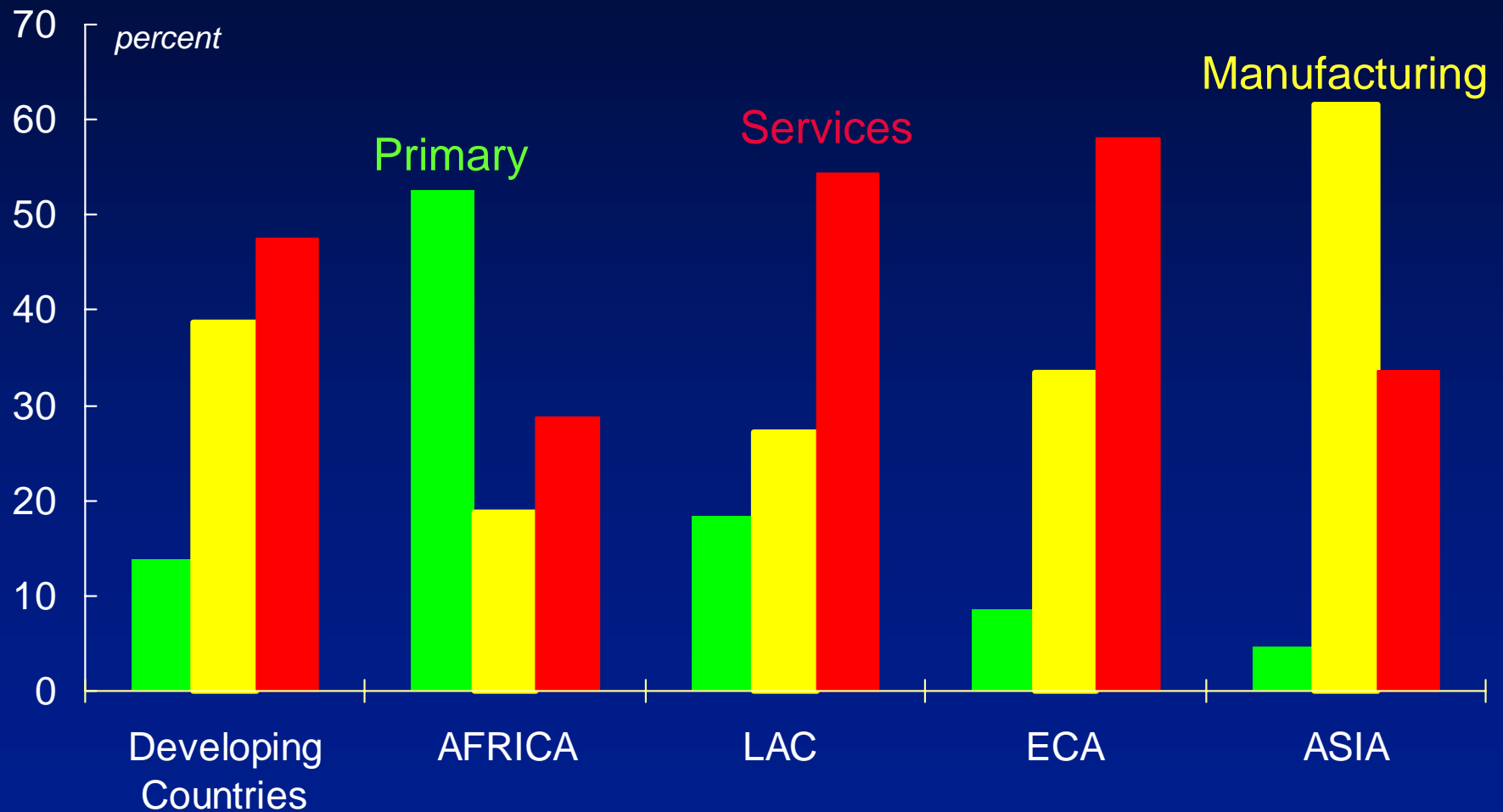
FDI-GDP Ratio





# FDI in Services Sector increased in 1990s

Share in total FDI Stock in 2002



Source: Global Development Finance 2004 (forthcoming in April), The World Bank

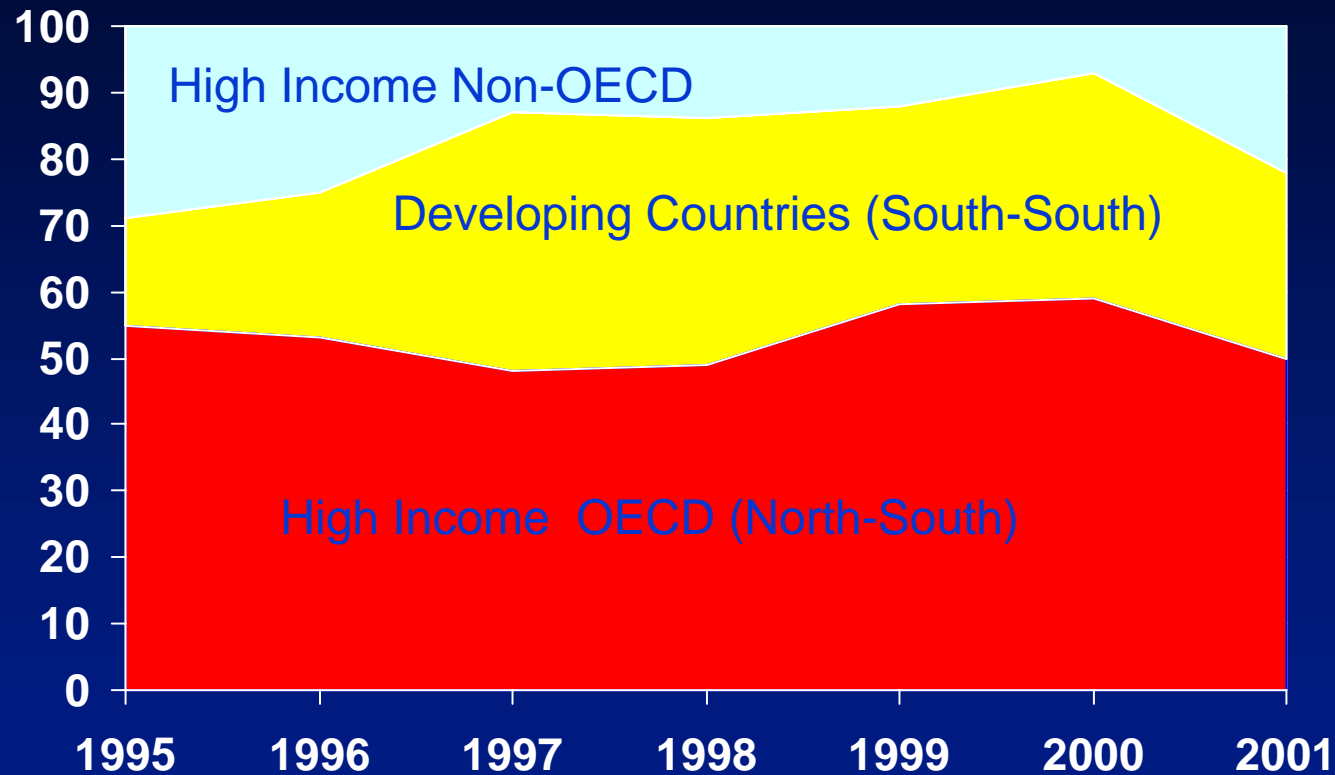
# Market-seeking activity has become the main driver of FDI

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- Primary Sector: Resource-seeking investment
- Manufacturing Sector:
  - Efficiency-seeking: Consumer electronics in China
  - Market-seeking: Auto industry in China (tariff-jumping)
- Services Sector:
  - Market-seeking: Retail, infrastructure and financial services (almost 20 % of total FDI flows)
  - Efficiency-seeking: IT and business services (e.g. Call centers) – (small share in total FDI)

# Developed countries are the main source of FDI in developing countries

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Source: Aykut and Ratha 2003

# South-South FDI in various sectors and regions

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- Latin America:
  - Major Brazilian TNCs in Argentina are Petrobras (fuel and petrochemicals), Brahma (beer) and Banco Itau (banking)
  - The foremost Chilean investors in Argentina are Gener (thermoelectric power), Masisa (chipboard), Luksic Group (beer) and Grupo Ibanez (supermarkets).
- Africa:
  - South African Breweries in Botswana, Lesotho, Swaziland, Tanzania, and Zambia; by Pepkor (retailer) in Zambia and Mozambique; NetGroup (electricity) in Tanzania.
  - Namibia's Electricity Distribution Management has expanded in the southern and eastern Africa.

# South-South FDI in various sectors and regions (cont'd)

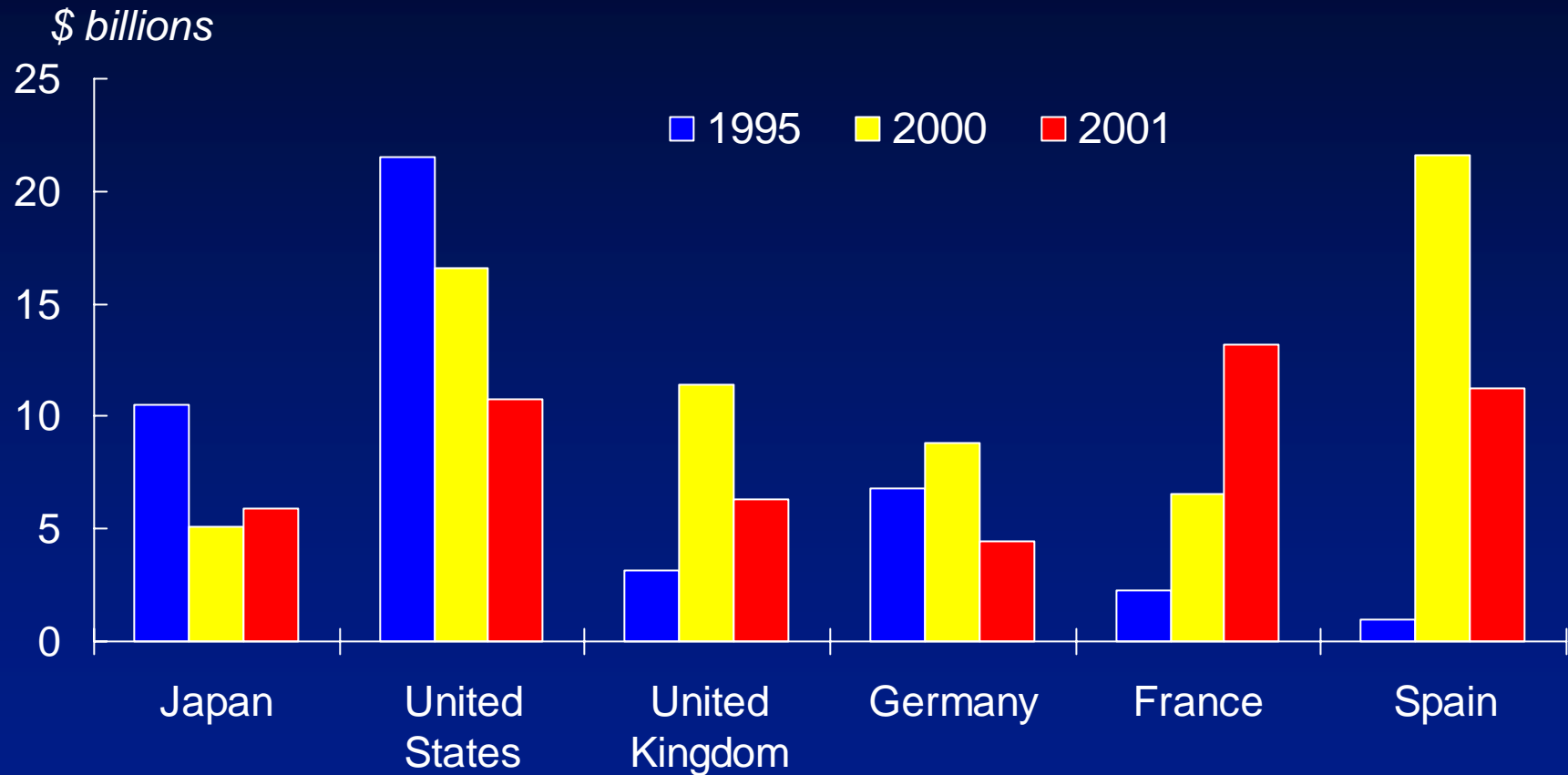
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- Asia:
  - China's direct investment in pulp projects in Chile and Russia, iron ore and steel mills in Peru, oil in Angola and Sudan.
  - Malaysia's Petronas (oil) had expanded into South Africa, Vietnam, Cambodia, Laos, Burma, Turkmenistan and, despite the threat of US sanctions, Iran.
- East Europe:
  - Turkey's Ceylan Holding (construction), Ziraat Bank and Demir Bank (finance) in Bulgaria

Source: Aykut and Ratha 2003

# The major North-South investors have evolved through time

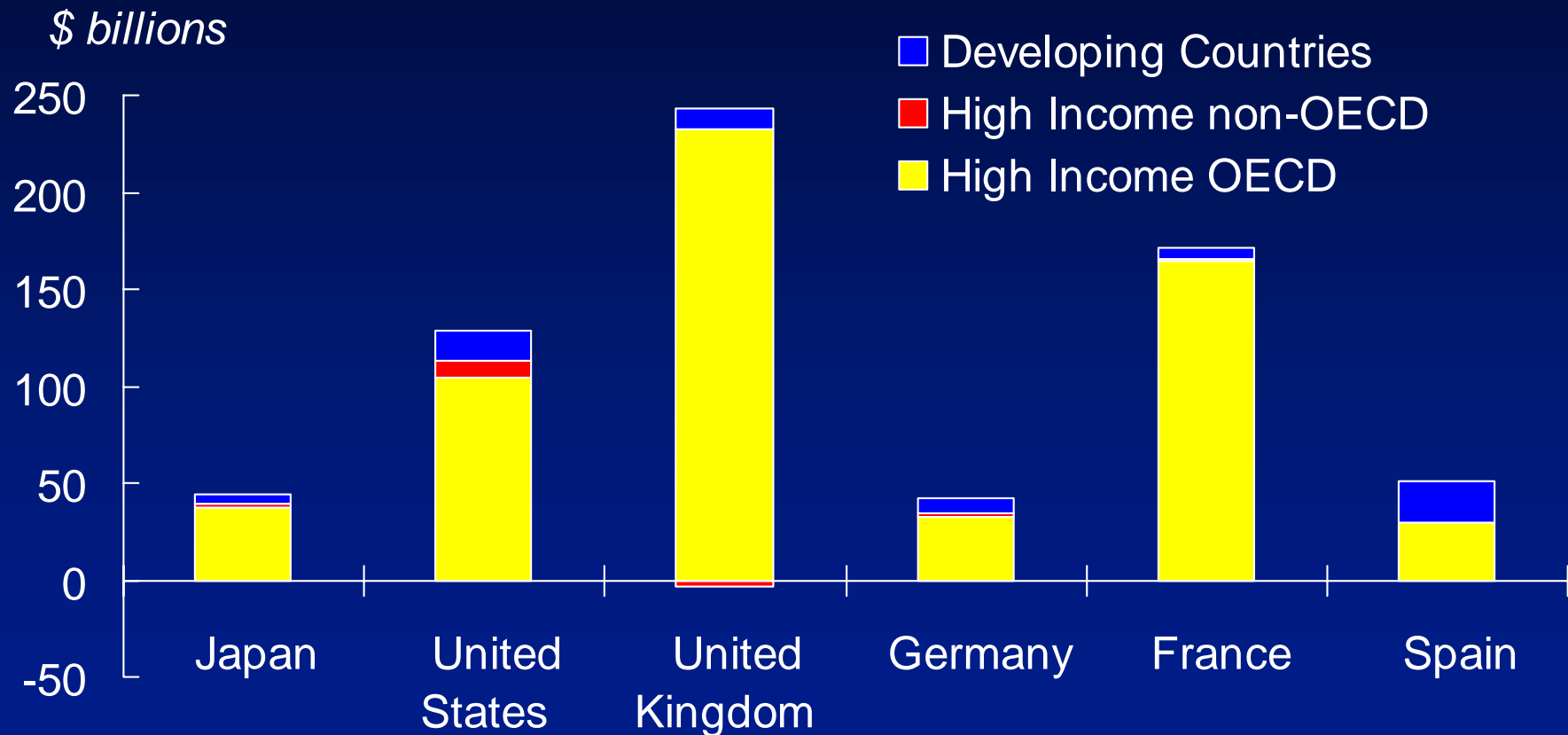
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Source: OECD, Direct Investment Database 2002; Country Sources.

# The share of developing countries in their investments has been small

Destination of FDI outflows from selected economies in 2000



Source: OECD, Direct Investment Database 2002

# Important Determinants of FDI: Investors' Perspective

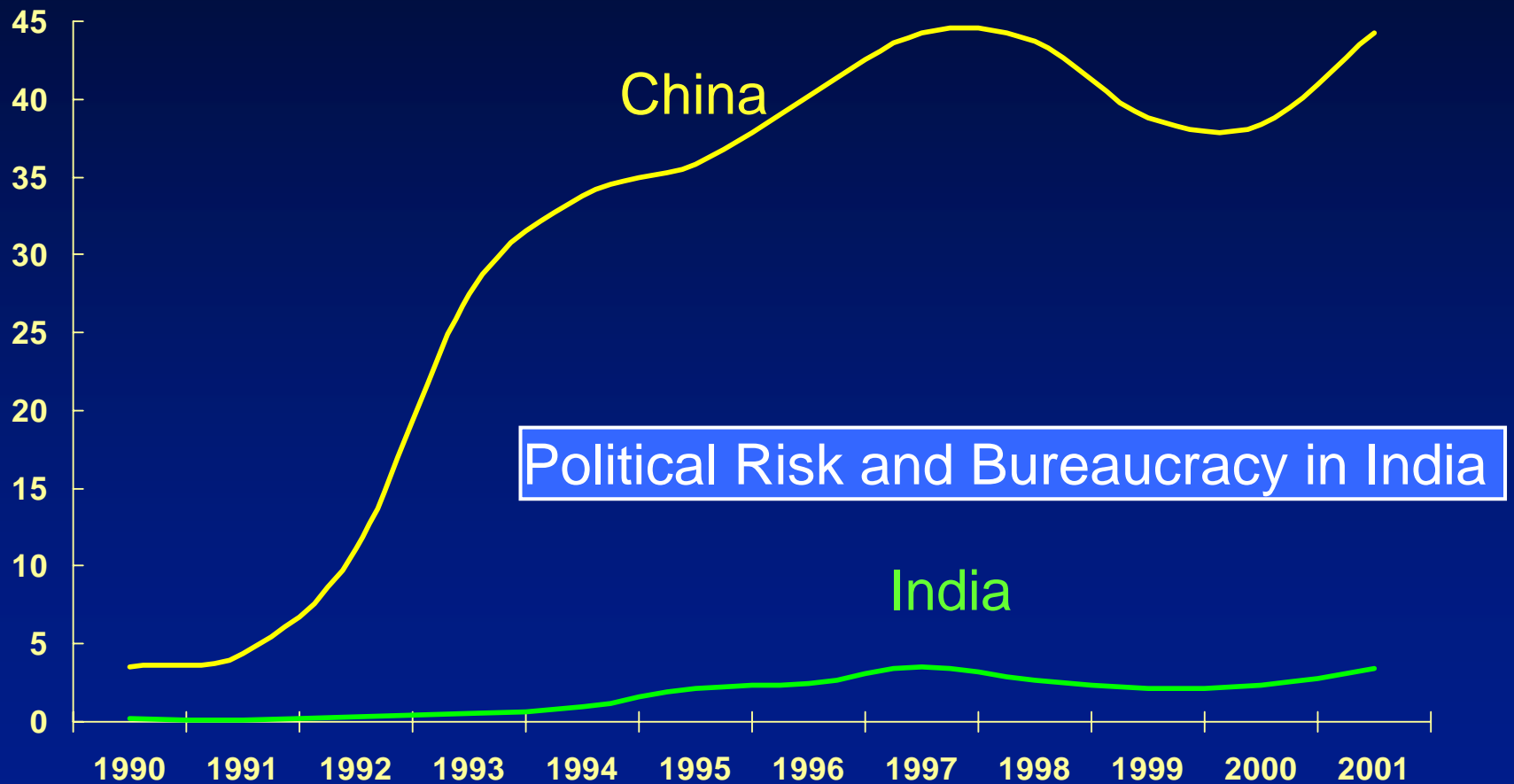
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- Political and economic stability
- Market size and prospects for growth
- Predictable rules for investment and a sound legal framework
- Availability of infrastructure
- Stability of the tax system is important, but tax incentives not critical in investment decisions
- Productivity of labor rather than low wages

\* Based on Capital Markets Consultative Group Survey, IMF and World Bank (2003)

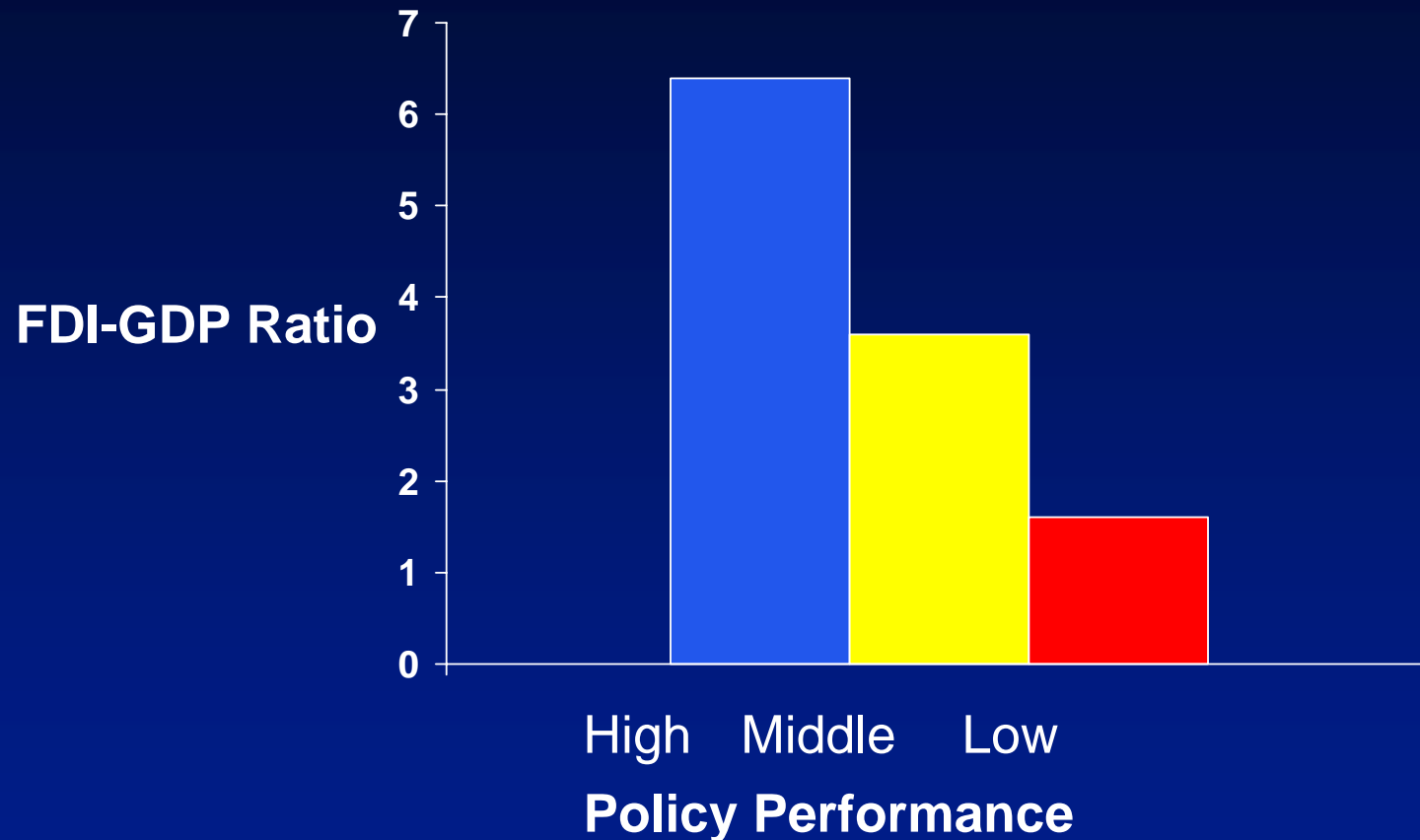


# Market size by itself is not decisive



# Improved investment climate is associated with higher FDI

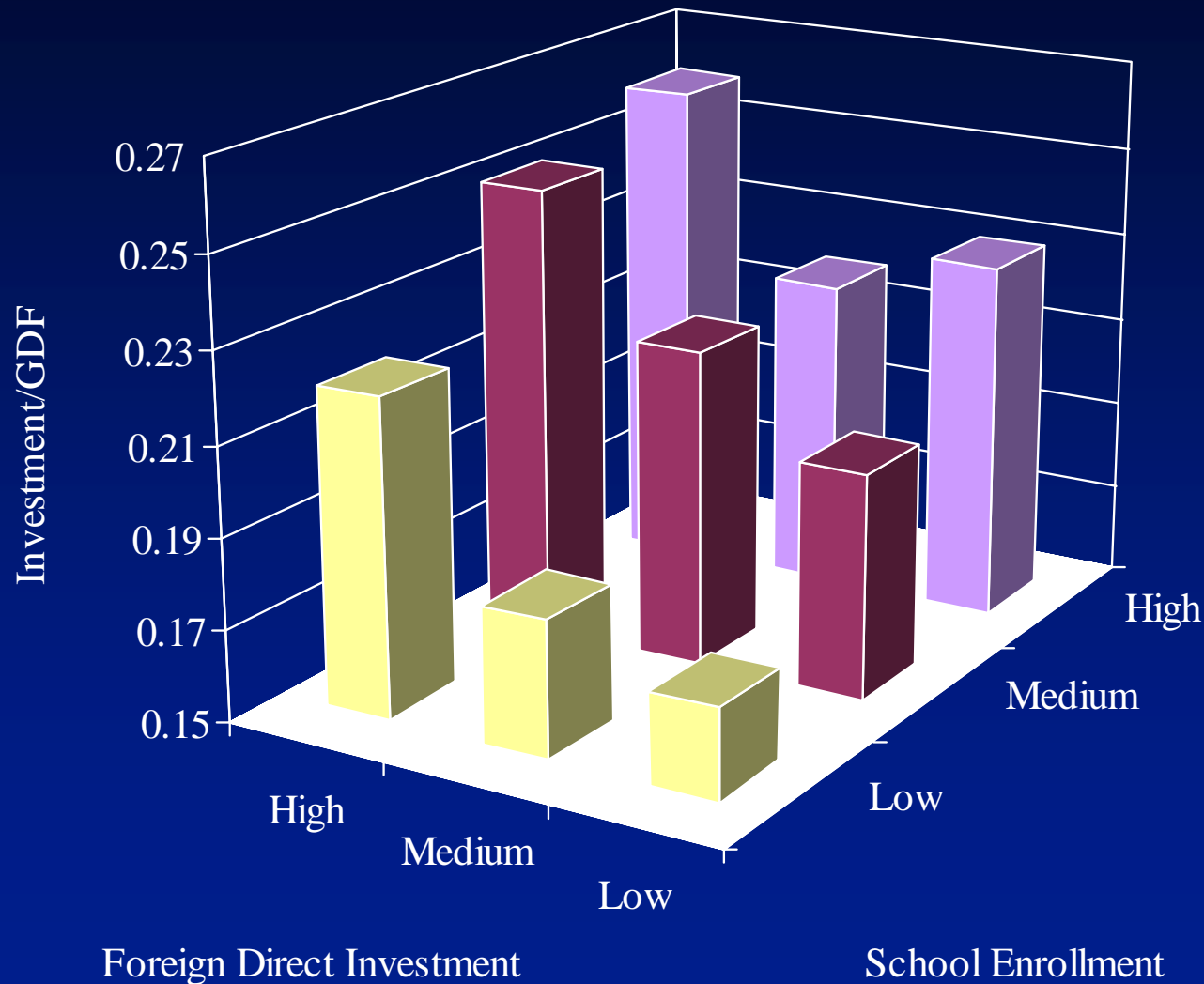
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*Note:* Averages are weighted averages for 1999–2002. Policy Performance is categorized based on the World Bank Country Performance Rating 2000

*Source:* Global Development Finance 2004 (forthcoming in April), The World Bank

# FDI is More Strongly Associated With Investment When There Are Higher Levels of Human Capital



Source: Global Development Finance 2001, The World Bank

## FDI generated employment for women in export-processing zones in developing countries

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Country	Women's Share (% of all workers)	Industry
Bangladesh (1998)	69	Garment, leather, shoes, and electronics
Dominican Republic (1999)	58	Garment and electronics
El Salvador (1997)	80	Garment and electronics
Fiji (1998)	80	Garment and Food
Madagascar (1997)	60	Garment
Mauritius (1997)	68	Garment and Flowers
Haiti (1998)	69	Garment

Source: Van Heerden, 1999

# Prospects for FDI

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- After two consecutive years of decline since 2002 and 2003, FDI flows to developing countries are expected to recover in 2004 and 2005
- As global economic growth recovers and investor sentiment improves, FDI to developing countries, especially to China, Mexico, Poland, India and Russia, are expected to recover
- China is once again expected to receive the highest share of FDI flows to developing countries. Although the manufacturing sector will remain to be the major sector, China is expected to receive larger amounts of FDI into its services sector in the medium term
- Other Asian countries (Malaysia, Thailand and Vietnam) as well as EU accession countries are also expected to receive higher levels of FDI in the medium term.
- Limited prospects for Africa because of limited growth potential; concerns about infrastructure, political risks, and labor productivity.

# Challenges in investment rule-making

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- Pattern of policy change: unilateral liberalization (9.5 to 1 ratio since 1986 according to UNCTAD data)
- Explosion of BITs since 1990, 2265 in existence today
- Growing number of RTAs with comprehensive investment provisions (protection and liberalization)
- Little evidence that BITs generate extra FDI
- FDI already in WTO via GATS, TRIMs, ASCM: not starting from scratch, need to promote coherence

# Who *needs* investment rules?

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- Key facts to consider:
- 2/3 of FDI flows are in services today (primacy of GATS; need to explore scope for making the GATS a more potent instrument of FDI liberalization – lock in the status quo; ratchet effect for autonomous liberalization?)
- 4 of 5 barriers to FDI also in services – yet a proposed WTO MFI would have been on investment in non-services

# Who *wants* a WTO-MFI?

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- Key proponents in the WTO:
- EU, Japan, Korea, Chinese Taipei, Switzerland, Canada: Perceptions of an “Anything but Farms” Alliance, i.e. investment and other Singapore issues in part as a bargaining chip in the DDA
- Behavior of EU and Korea at Cancun reinforced the above perception
- Private sector indifference or outright hostility in the US



# Additional reasons for blockage

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- DDA stalemate on issues of priority interest to developing countries
- Post Uruguay Round quest for preserving policy space
- Rigid bundling of the Singapore issues raised suspicions
- Lingering effects of the MAI fiasco, despite significant differences in content and in levels of ambition
- Perception of a lack of value-added in what was on the table (i.e. a deal on FDI in non-services)
- Not starting from a blank page: confronting the challenge of existing rules and commitments (not an issue in RTAs)

# **Investment rule-making consists of 4 key sub-agendas**

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- **Investment protection**
- **Investment liberalization**
- **Investment distortions**
- **Good governance (complimentary means of enhancing the investment climate)**

# Investment Protection

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- Much treaty-making activity in recent years, in BITs and RTAs, several of which involving Japan
- Not on the Doha Agenda: NAFTA-MAI after effects; rising judicial activism; no scope for investor-state dispute settlement in the WTO; negotiating asymmetries between home and host countries
- OECD country concern: multilateral dilution of strong bilateral standards
- Economies of scale in rule-making for developing countries (spaghetti bowl effect); overcoming asymmetrical North-South bargaining
- Bottom line: bilateralism and regionalism rules

# Investment liberalization

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- Much Ado About Services (2/3 of flows; 4/5 of barriers)
- Large gap between bound and applied liberalization in GATS (rules allow it); most RTAs pursue a negative list approach, so lock in the *status quo*
- Limited evidence of policy reversal: lock-in effect of BITs, which make reversal costly
- Is the political economy of FDI different from that of goods trade? Is the value of bound commitments – hence of negotiations – lesser? Ditto for services?

## Investment liberalization (cont.)

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- Lack of coherence of proposed rules: an MFI on FDI in non-services
- With protection off the table, what is the market access agenda in non-services?
- How attractive is the prospect of parallel rules on investment in goods under the GATT and on FDI in services under the GATS? Business turn off; reinforces the attractiveness of bilateral and regional approaches

# Investment liberalization (contd.)

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- Towards a Grand Bargain on FDI and Labor Mobility?
- Affirming the conceptual and legal equivalence between the movements of K and L (as is commonly done in many RTAs)
- Can we devise incentives for an improved treatment of labor mobility issues in return for FDI lock-in?
- GATS would then focus on Modes 1 and 2, with commitments by OECD countries not to restrict business process outsourcing under Mode 1
- Challenges: reopening balance of concessions under GATS (easy on Mode 4 given limited advances, harder on Mode 3). Overcoming the bureaucratic resistance of services negotiators. Can regional advances and precedents encourage subsequent WTO migration (after the DDA)?

# Investment distortions

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- Much Ado About Manufacturing and involving 3 core issues
- TRIMS/performance requirements: extensively prohibited in RTAs, but WTO ban broader than commonly assumed, making all inconsistent TRIMs potentially liable to legal challenge under GATT
- Investment incentives: clear revealed preference for rule-making inaction, especially in federal states, and in a growing number of developing countries. Need to explore the scope for regional collective action responses, as locational competition is rarely global in scope

# Investment distortions (contd.)

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- Investment-related trade measures (IRTMs): there are a host of investment distorting trade measures that can be addressed under the DDA without the need for an MFI
- These include: anti-dumping (also in RTAs); discriminatory rules of origin in RTAs; tariff escalation and tariff peaks; unduly onerous TBT or SPS requirements; lack of recognition of product standards, all of which distort FDI flows away from what the forces of comparative advantage should otherwise dictate
- This is not a one-way street: there is much developing countries can do to enhance their investment climates and attract better FDI: integrate production networks via lower tariffs; elimination of red tape and administrative barriers in pre-establishment; adoption of international standards



# Good governance

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- Arguably not a WTO responsibility – need for a coherence-promoting cosmopolitan approach based on soft law treatment of issues such as:
- Transparency (how can this be enforced in the WTO?TPRM/peer review approach preferable)
- Bribery/corruption
- Corporate Social Responsibility
- Incentives to enhanced labor/environmental standards (EU GSP?)
- Best practices in investment promotion
- Home country measures to encourage more FDI in developing countries, especially LDCs

# A few closing thoughts on services

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- Very broad similarities with FDI in terms of overall political economy (not surprising given the importance of FDI as a means of accessing services markets)
- Strong learning journey via trade rule-making since the mid-1980s; clear iterative process between bilateral, regional and multilateral negotiations
- There is much that FTAs can do to advance the cause of services rule-making, and also liberalization in some sectors, though on balance hard issues and sectors are the same regardless of the negotiating setting

# Services (contd.)

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- Liberalization advances tend to be limited to *status quo* commitments, thanks in part to negative list approaches in many RTAs
- Few rule-making advances at the regional level in areas that pose difficulties in Geneva: domestic regulation, emergency safeguards, subsidies, procurement. More progress on Mode 4
- Some sectors seem immune from market opening in any setting: civil aviation; maritime transport; audio-visual; education; health; still little to report on energy services
- Useful learning on the nexus between external liberalization and pro-competitive domestic regulation, especially in telecoms. This should be replicable in other network-based industries, resulting in the incipient multilateralization of competition law

## Services (contd.)

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- Much virtue in domestic policy; little of it is reflected in trade agreements – but liberal policies are not being reversed, potentially lessening the value of bound commitments?
- Limits to reciprocal bargaining remains a major constraint: developing countries not yet general demandeurs at the negotiating table: service sector reforms are pursued on domestic efficiency grounds, not so much with a view to promoting service exports

# Services (contd. and end!)

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- Regional advances matter, since they tend to be applied on an MFN basis *de facto*, as it is costly and inefficient to maintain preferential regulatory regimes
- Few disputes to date at the WTO level or under RTAs: good news or a reflection of limited market opening and rule-making advances?
- Two key cases at the WTO: US-Mexico in telecoms highlights the importance of pro-competitive regulation as a complement to effective market access; and US-Antigua on online gambling reveals the scope for surprises in scheduling open commitments in new areas where technological developments may not be properly anticipated.
- Will this have a chilling effect on future Mode 1 liberalization?
- Paradoxical to see the US lose an e-commerce case at the WTO! But good news to see that a country with a population of 65000 can win a DSU case against a large, lawyer-infested, WTO Member! A clear case of right over might!