FDI: Regulation, Crisis, and Future Prospects

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Outline

- FDI Regulation

- Crisis & FDI
  - FDI as an alternative to other types of investment/allocations of funds
  - Sovereign Wealth Funds (SWFs)

- Future Prospects

FDI Regulation: State of Play

- Multilateral investment rules
  - A tale of successive disappointments since the 1940s
  - <u>Nothing to do with trade in terms of achievements</u>

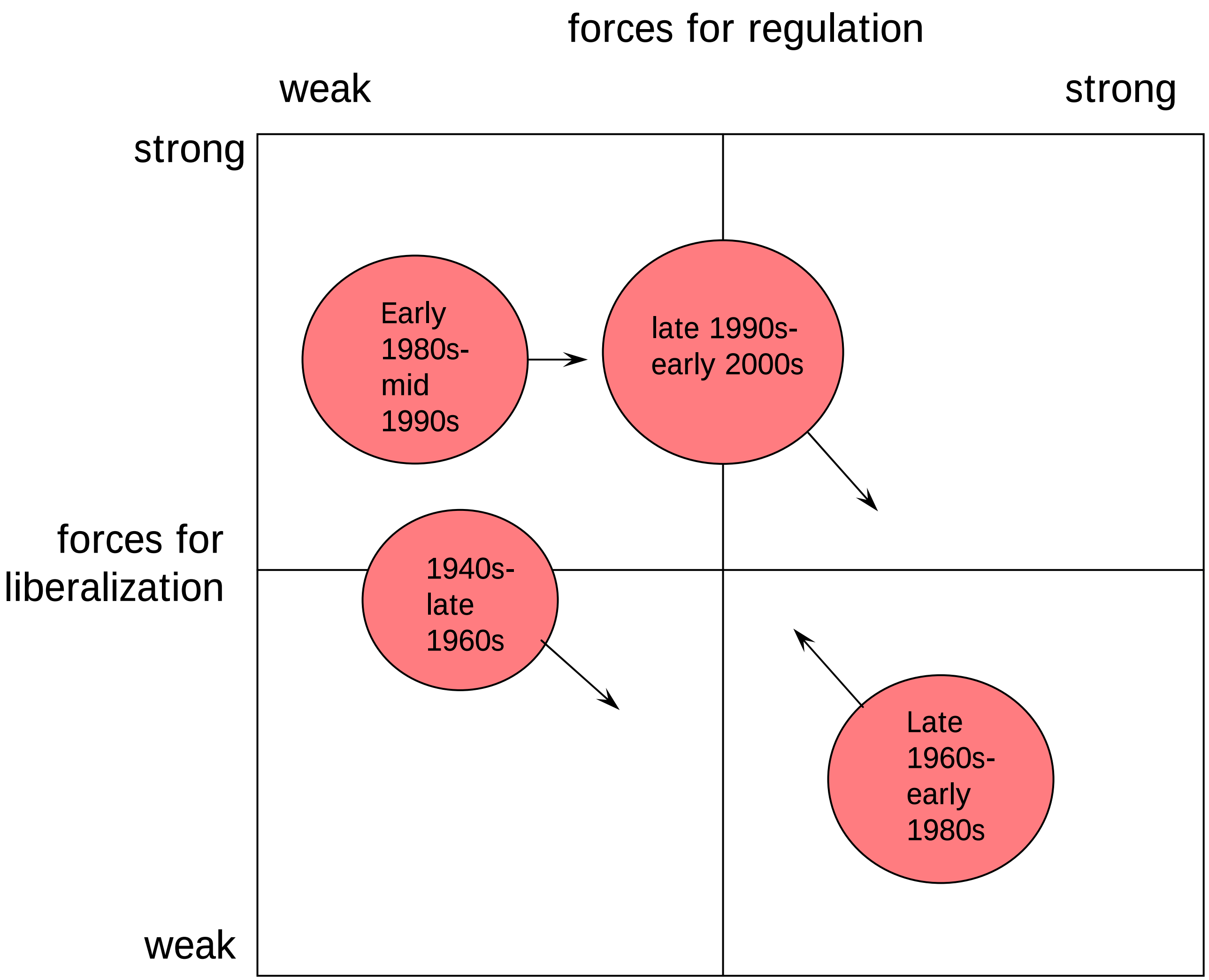
- FDI-related aspects largely ignored until Uruguay Round negotiations
  - Despite a range of initiatives: OECD (binding codes, Guidelines for MNEs, draft MAI), UN (draft Code of Conduct on TNCs)
  - Uruguay Round Agreements: investment back as part of a package
    - TRIMs, GATS, TRIPs, Agreement on Subsidies and Countervailing Measures, Agreement on Dispute Settlement Understanding

- Doha ("development") Round: includes investment-related items
  - Setback in Cancun (2003)

- Agreements with investment in mind: limited in scope and integration

Sources: Tavares & Young (2004); Young & Tavares-Lehmann (2007)

FDI Regulation: The Shifting Policy Pendulum



Source: Brewer and Young 2001

FDI Regulation: State of Play

- Architecture of investment rules: multiple overlapping (and potentially contradictory) levels
  - Multilateral, macro-regional, national/bilateral and sub-national/ micro-regional; asymmetric importance between & within levels
  - Problems of systemic coordination

- Proliferation of bilateral & plurilateral agreements
  - At the end of 2007:
    - 5600 international investment agreements (IIAs)
    - 2608 BITs (254 Free Trade Agreements) - fragmentation
  - Yet: BITs are not important FDI determinants
  - Lack of measurable benefits from multilateralism when compared to high costs of adjustment and reduced government autonomy

Are multilateral investment rules desirable? Theoretical perspectives

- Benefits of rules-based multilateral investment regime
  - <u>Equivalent of gains-from-trade argument:</u> national and global <u>welfare gains</u>
  - Prevents deadweight losses implied by protectionist behaviour and the absence of a harmonized framework
  - However, FDI more complex issue than trade

- Limit waste of resources due to incentives' escalation

- Multilateral rules would lock-in liberalization & protection measures
  - Transparency and openness; reduction of uncertainty & transaction costs

- Political economy argument: improvement in MNEs-Govt relations

Barriers to progress on a multilateral investment regime

- Three key and interrelated barriers :
  - Relationship between multilateral rules & domestic priorities
  - Balance between rights of MNEs & obligations of countries
  - Asymmetries between home countries for FDI (Decision-making processes and bargaining power)

- Countries wanted control over pace, sequencing and direction of liberalization and reform

- Failure of progress at multilateral level determined emergence of other alternatives

- Issues of supranational governance
  - Roles of WTO, IMF and World Bank – "the problem of the forum"

Are multilateral investment rules actually achievable (or desirable)?
Political economy and institutional perspectives

- Problems of achieving a multilateral system
  - Dilemmas posed by relationships between globalization, the nation State and democratic politics
    - Requirements for achieving the benefits of deep integration are very demanding
    - Rodrik (2000): a requirement for deep integration is *either* removing the sovereignty of the nation State *or* abandoning domestic politics – 2 options unlikely to be feasible together
    - Stiglitz (2002): in the absence of any kind of global government, deep integration tends to have a profoundly anti-democratic nature

Options for Progress

- Rules-based approach through multilateralism, but limited progress likely
- Multilateralising regionalism
- Quasi rules-based approach, with gradation of rules:
  - ✓ Legally-binding core principles
  - ✓ EU-type system of Regulations and Directives
  - ✓ Gradation of rules according to principles, such as level of economic development
- Combined rules-based and voluntary approach
  - ✓ Legally-binding core principles
  - ✓ Voluntary approach for wider range of corporate citizenship/ corporate social responsibility issues

Crisis

- Added new uncertainties and risks to the world economy
- Liquidity crisis in money & debt markets in many developed countries
  - Decrease in M&A activity (29% drop 1st half 2008 *vis-à-vis* 2nd half 2007)
  - Corporate profits and syndicated bank loans are declining
- Credit crisis (crunch)
- To what extent will FDI be affected?
  - UNCTAD estimates FDI in 2008 to be $1600 billion (10% decline)
  - UNCTAD survey to investors: nearly 60% expect financial instability to have <u>no</u> impact on FDI flows 2008-2010; 30% expect a negative impact)
  - Impact mitigated on developing countries (resilient growth)
- Will it be more or less affected than other types of investment?
  - Portfolio, hedge funds, ...

Crisis

- Micro- and macroeconomic impacts affecting the capacity of firms to invest abroad appear to have been relatively limited thus far

- MNEs in most sectors had ample liquidity to finance their investments
  - WIR 2008: high profitability MNEs
  - Importance of reinvested earnings (30% share world FDI inflows in 2007)

- Better investment climate in many economies

- Weakening of a currency (USD recently) stimulates FDI

- Increase of FDI in extractive industries – due to rising commodity prices

- Opportunities for FDI in infrastructure, mainly in developing countries
  - Openness varies by industry (+ in mobile telecoms, - in water)

Sovereign Wealth Funds

- Special investment funds to hold foreign assets for long-term purposes
  - Driven by export surpluses – rapid accumulation of reserves
  - 70 funds in 44 countries
    - Holdings concentrated in United Arab Emirates, China, Hong Kong (China), Norway, Kuwait, Saudi Arabia, Singapore, Russia
    - Higher risk tolerance and higher expected returns than traditional official reserves managed by monetary authorities

- Not a new phenomenon: 1950s
  - Kuwait Investment Authority (KIA): 1953; Temasek: 1974

- ...but new role in the FDI scene (as direct investors)
  - Involvement in some large-scale cross-border M&As
  - Capital injections to troubled financial institutions
  - New investment opportunities

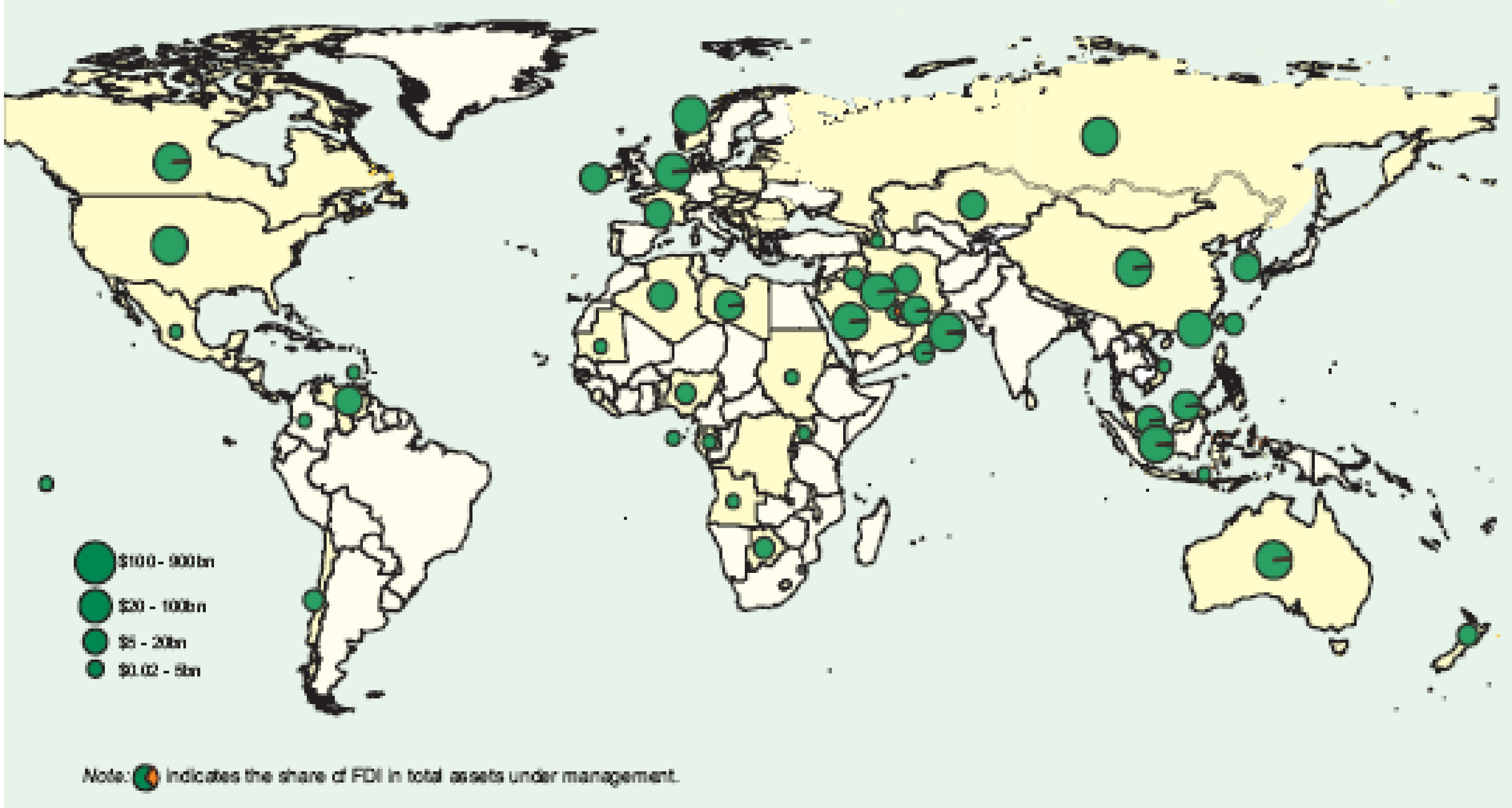
Sovereign Wealth Funds

- 5 trillion assets under management (~9 X private equity)
  - From $ 500 billion in 1990; estimated to be $10-14 trillion in 2012
  - ADIA ($875 bn, GPF-G Norway=373, Singapore GIC=330)
  - Yet only 0.2% of their total assets in 2007 were related to FDI (10 billion, 0,6% of total FDI flows)
  - But growing fast
  - Geographically and sectorally concentrated
    - 75% in developed countries (US, UK, Germany); 73% in services

- Objectives vary (asset allocation & risk management behaviour too)
  - Wealth preservation: economic rationale; ‘long’ investment strategies
  - Political weapons?

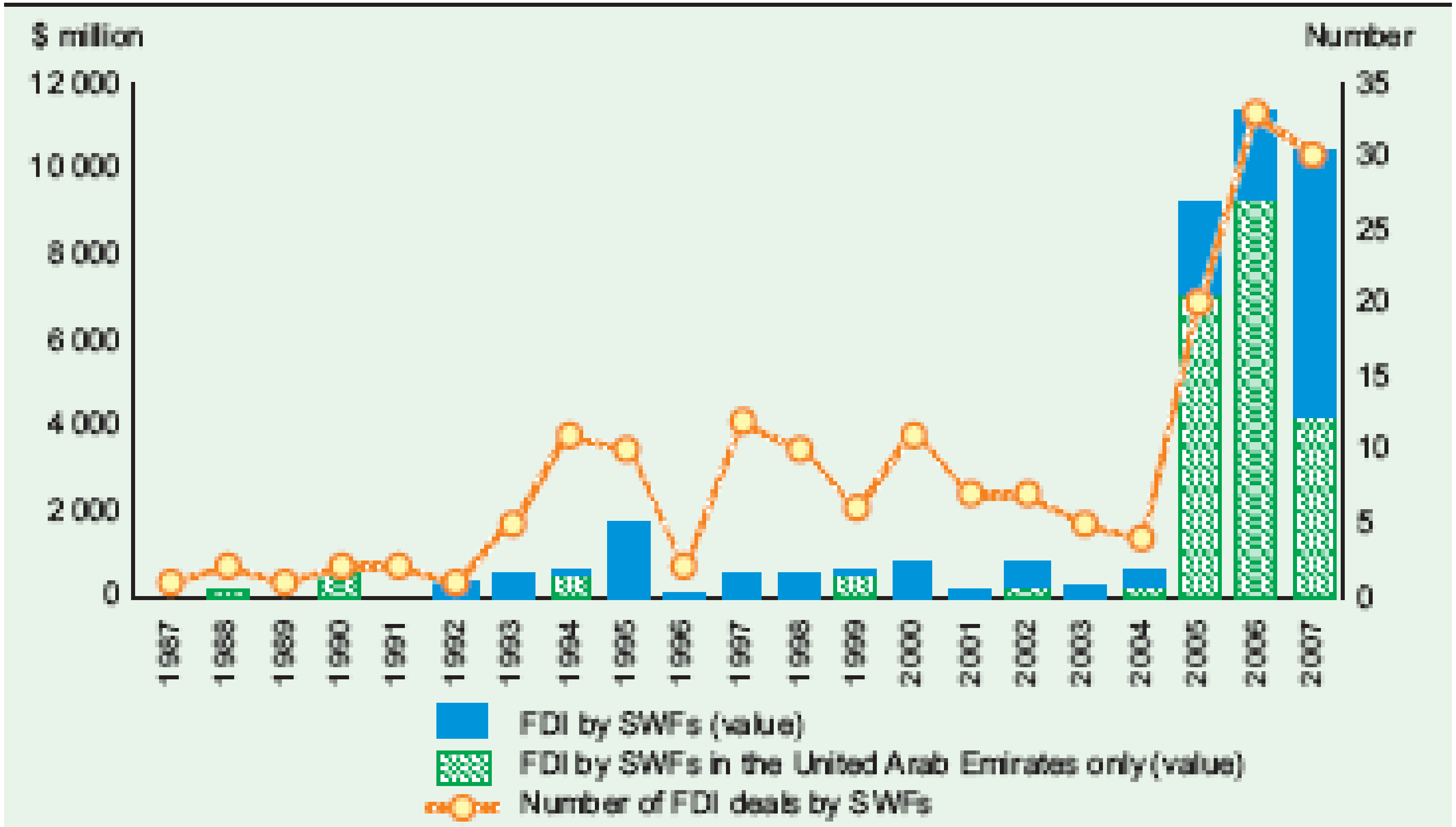
- Lack of transparency
  - Except Norwegian, Canadian and Kuwaiti
  - Aggravates systemic risks; SWFs not covered by conventional regulatory requirements

Figure I.19. Major FDI locations of sovereign wealth funds, 2007



Source: UNCTAD, based on annex table A.I.11.

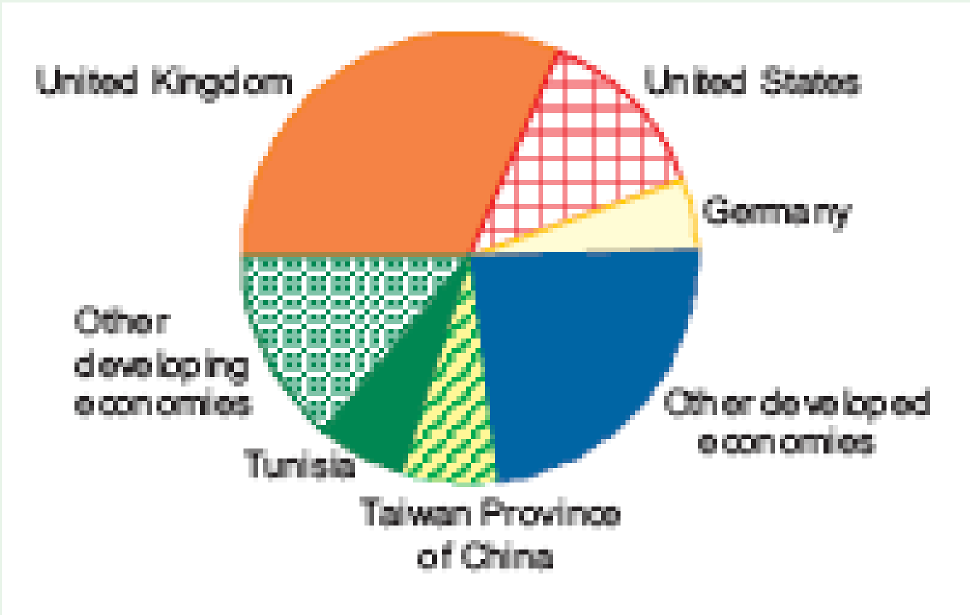
Figure I.20. FDI flows[a] by sovereign wealth funds, 1987–2007



Source: UNCTAD cross-border M&A database (www.unctad.org/fdistatistics).

[a] Cross-border M&As only. Greenfield investments by SWFs are assumed to be extremely limited.

Figure I.21. FDI[a] by SWFs, by main host groups and top five host economies, end 2007[b]
(Per cent)

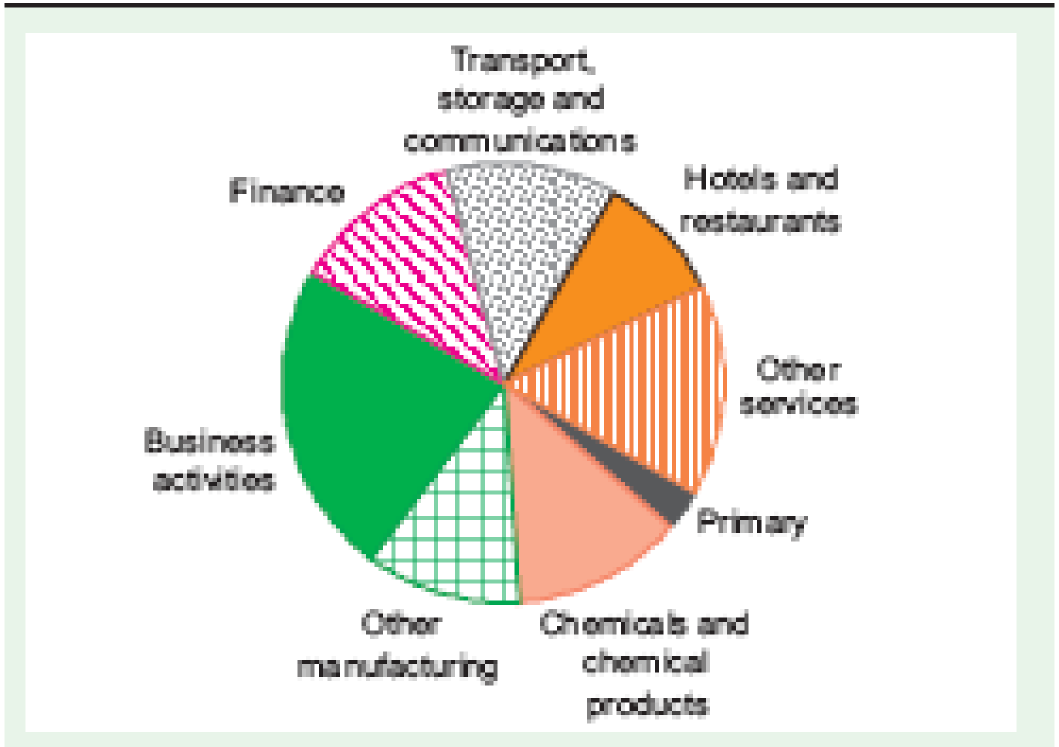


Source: UNCTAD, based on annex table A.I.13.

[a] Cross-border M&As only. Greenfield investments by SWFs are assumed to be extremely limited.

[b] Cumulative investments (M&As) between 1987 and 2007.

Figure I.22. FDI[a] by SWFs, by main target sectors and top five target industries, end 2007[b]
(Per cent)



Source: UNCTAD, based on annex table A.I.14.

[a] Cross-border M&As only. Greenfield investments by SWFs are assumed to be extremely limited.

[b] Cumulative investments (M&As) between 1987 and 2007.

Sovereign Wealth Funds

- Welcome impact: stabilizing effect on financial markets
  - Intertemporal stabilization: can help shield the economy against volatility in markets; fund serves as a ‘liquidity pool’
  - Highly professional investment vehicles
  - *“SWF flows may be the new recycling mechanism to drive a growth agenda” (Danny Leipziger, VP World Bank)*

- Still, attracted some negative sentiment – national security
  - Debate often politically charged

- Debate over protectionism
  - Policy focus should rather be on enhancing transparency & accountability – corporate governance standards; open markets/reciprocity in access; political intervention as a last resort

- Debate over sustainability of FDI by SWFs ... and by private equity

Future prospects
…and what about Portugal as a host country?

- Lack of harmonization likely
  - Would harmonization be interesting?

- Interesting opportunities as some funds may shift from short-term to long-term (FDI) ‘real’ investments

- Portugal’s positioning as FDI host country
  - Specialization profile?
  - Redesign of incentives?

- Outward investments
  - Plenty of bargains available