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Or. Eng.

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**WORKSHOP ON FDI LIBERALISATION, FINANCIAL CRISES AND
MULTILATERAL RULES FOR INVESTMENT**

This note contains the summary of discussion and conclusions of a Workshop held in Bangkok on 9-10 November 1998. It is provided for information and discussion for the CIME meeting on 23 November 1998.

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WORKSHOP ON FDI LIBERALISATION, FINANCIAL CRISES AND MULTILATERAL RULES FOR INVESTMENT

Bangkok, Thailand - 9-10 November 1998

I. Introduction and overview

1. In the context of the OECD's Special Programme for Asia, a workshop on foreign direct investment liberalisation, financial crises and multilateral rules for investment was held in Bangkok, Thailand, on 9 and 10 November 1998. The Office of the Board of Investment of Thailand was host to this meeting, which was attended by 53 participants from 13 Member countries, 10 non-Members (China; Hong Kong, China; India; Indonesia; Malaysia; the Philippines, Singapore, Chinese Taipei, Thailand and Vietnam), the European Commission, the Asian Development Bank and the World Bank.
2. The documentation included a study of foreign direct investment trends and policies in four Asian countries that have been hit severely by the financial crisis (Indonesia, Malaysia, the Philippines and Thailand), prepared by the Secretariat and an independent consultant [CCNM/SPA/CIME(98)3-6].
3. This note offers a summary of the discussion at the workshop (section 3), preceded by a number of conclusions, which has been prepared on the responsibility of the Secretariat.
4. East and Southeast Asia have been among the most popular destinations for foreign direct investment (FDI) outside of the OECD area for the past decade. Many of these countries have encouraged FDI as a means of generating export-led growth, often with impressive results. Although FDI may often account for only a small share of total private investment within many economies, foreign firms have dominated many of the most dynamic and outward oriented sectors.
5. Furthermore, FDI has been significantly more stable than other forms of capital flows during the crisis. While net FDI flows to Asia and other net private flows each represented around \$55 billion in 1996, the latter group (principally bank lending) had switched to a net outflow of \$44 billion by 1997. In contrast, net FDI flows remained unchanged in 1997. Not only have most existing foreign investors remained in the region, but many newcomers have established operations in order to take advantage of future sales and export opportunities. While there may be some cyclical decline in FDI to the region in the short term, these economies are likely to retain their appeal to foreign investors over the longer term.
6. Far from causing a backlash against FDI, the financial crisis has encouraged many Asian countries to create a more welcoming climate. To some extent, this may reflect a sense of emergency rather than a genuine reappraisal of the potential benefits of FDI, since a number of the measures are temporary. It remains to be seen whether these measures will remain for a sufficient time to allow a more fundamental shift in perception to take hold in host economies. Some measures are intended for only a relatively short period of time, while others apply for rather long periods (up to 10 years).
7. Many of these measures allow greater scope for foreign investment in the production of goods and services oriented towards the domestic market. In this area, some host economies in Asia had started to lag behind policy liberalisation in prominent Latin American countries. Significant measures have been taken in, for example, the financial sector in a number of countries. As a result, the gap between bound

commitments under the GATS Financial Services Agreement of December 1997 and the current regulatory situation has widened further

8. In spite of recent policy initiatives, many Asian countries continue to be reluctant to accept multilateral legal obligations to liberalise: there is a preference for BITs, for agreements within the ASEAN context and for non-binding principles. However, most Asian participants at this meeting had an open mind on the possibility of their countries' participation in a discussion of a multilateral framework for investment, as long as it would not imply a presumption that they would sign a multilateral agreement.

9. It was stressed that liberalisation in itself does not guarantee that the potential benefits of FDI are realised. For example, in the financial sector, liberalisation, reform of financial markets and strengthening of prudential supervision should go hand in hand.¹ More generally, FDI liberalisation should be accompanied by trade policy reform, competition policies and other reforms designed to improve the overall climate for both domestic and foreign investors.

10. The more welcoming climate for FDI offers prospects for a fruitful dialogue with Asian countries. Such a dialogue could help to bring about a more fundamental and lasting change in the perception of the benefits of FDI, thus serving to encourage further liberalisation of FDI regimes in Asia, including making recent short term liberalisation measures more permanent. The dialogue could also clarify ways to ensure that the overall policy environment in place is appropriate in order to promote both domestic and foreign investment and to derive the most benefit from that investment.

11. Further dialogue could also provide feedback to Asian countries on trends in FDI and FDI policies in OECD countries and in those South American countries adhering to the OECD instruments and could provide OECD countries with developing country views about the possible need for multilateral investment disciplines.

II. Summary of the discussion

12. Five broad issues were discussed at the workshop: (i) the trends of FDI in East and Southeast Asia, (ii) the policies on FDI pursued in response to the recent financial crisis, (iii) the potential benefits of FDI, and how to realise them, (iv) FDI and financial fragility and (v) multilateral investment disciplines.

Trends of FDI in Asia

13. The analysis of trends revealed that the mid-1980s had marked a watershed for many countries in the region: from those years onward, FDI in South-East Asia started to increase significantly. Much of this investment came from a delocalisation of production by companies from, in particular, Japan and Korea, and also from Singapore and Chinese Taipei. In this way, these companies sought to mitigate the rising production costs in their home countries. These costs were being propelled by the real effective rise of the yen after the Plaza Accord of early 1985, as well as the rapid increase in real estate prices and wage costs. The abolition for some countries of the Generalised System of Preferences also stimulated a delocalisation towards countries which still enjoyed the benefits of this System.

1. The interface between financial reform and FDI in the financial sector could be the subject of a future workshop to be organised under the joint responsibility of CIME, the CMIT Committee and the Committee on Financial Markets.

14. This trend towards delocalisation, to serve the home market from abroad, fitted well with the emphasis that some of the host countries put on export promotion. This was a change in orientation, since FDI used to serve first and foremost as a vehicle for import substitution. Malaysia and Singapore were trend-setters and, indeed, these countries were among the first to play a very prominent role as recipients of FDI aimed at export promotion. Thailand also switched towards export promotion in the 1980s. Other countries in the region, such as the Philippines, China and Indonesia would follow suit in the 1990s.

15. Although FDI has been important in certain fast growing sectors, it has not often represented a significant share of total private investment, except in Malaysia and Singapore. In Thailand, FDI hardly ever rose much above 5 per cent of total investment. In some other Asian countries, such as Korea, this percentage was even lower. These countries relied heavily on foreign loans alongside direct investment, or even largely instead of FDI.

16. When the crisis broke in July 1997, this pattern changed. The inflow of foreign loans and portfolio investment into the region reversed sharply into a large net outflow. However, foreign direct investment showed resilience and, over 1997, hardly changed as compared to the year before. For 1998, some slowdown is expected. There are negative factors, such as a slowing of domestic demand, which means that FDI in production that predominantly serves the Asian market, is bound to suffer. Investments from countries affected by the crisis will decline. FDI into China, Myanmar and Vietnam, is bound to feel this effect. On the bright side, however, export-oriented investment is offered better opportunities, not least as a result of fallen asset prices and of greater possibilities for the acquisition of Asian enterprises. Higher investments from Europe and the US may compensate for the reduction of outward FDI from Asian countries.

17. Another interesting trend was that the average size of new investment projects has been declining. This suggests that, rather than the largest enterprises, it is the smaller or more labour-intensive projects that constitute the most stable element in foreign investment flows. The phenomenon may be due in part to the opening up, in some countries, of sectors like retail and wholesale trading, in which many smaller firms operate.

18. It emerged from the discussion that demand, and thus competition, for FDI has increased. Several speakers pointed to China as the most successful competitor, but it is a country that also offers proven opportunities for Asian outward investors. However, the potential of another region -- Latin America -- to compete with Asia as a destination for FDI should not be overlooked. All this is stimulating co-operation within the ASEAN; indeed, an ASEAN Investment Area Framework Agreement has been signed. Further measures to attract FDI into the region are expected to be announced at the ASEAN Leaders' meeting in Hanoi, in December 1998.

Response of FDI policies to the financial crisis

19. How have FDI policies in Asia responded to the recent crisis? No country reported that it had restricted FDI further. Malaysia introduced pervasive currency restrictions as of 1 September 1998, but it was emphasised from the Malaysian side that these restrictions did not take aim at direct investment, but rather at thwarting speculative portfolio flows. Otherwise, the general picture was that countries affected by the crisis had sought to create a more welcoming climate for FDI in response. Four broad categories of measures on FDI could be identified: liberalisation, deregulation, facilitation and the offering of incentives.

20. *Liberalisation* has taken place in the form of opening production sectors hitherto closed for FDI, or of the introduction of majority foreign ownership, in certain cases up to 100 per cent. The full liberalisation of foreign take-overs in Korea (outside the limited number of restricted sectors) is a conspicuous case in point, since it represents a fundamental shift in philosophy in this country. In some countries, liberalisation measures are temporary: *e.g.* full foreign ownership of financial institutions in Thailand is offered for ten years only.

21. *Deregulation* has taken place in real estate: in several countries, such as Thailand and Korea, leasing of real estate by foreigners has been made possible for longer periods, which have also been made renewable. In certain countries (*i.a.* Thailand, Indonesia), enterprises have been offered a wider choice in selecting their sites of establishment. Other deregulation has consisted in the temporary cancellation of export requirements.

22. *Facilitation* has been seen in the easier and speedier provision of visas and work permits, and in the more active role of investment agencies in 'matchmaking' between domestic enterprises and foreign investors. Application procedures have been simplified, such as in Indonesia, where much of the decision-making has been transferred from the President to other central or even regional bodies, one-stop centres were introduced for obtaining local permits and inter-ministerial letters of recommendation have been abolished.

23. Finally, *incentives* have been offered in the form of extended tax holidays, sometimes very lengthy ones (up to 10 years in Korea). Exemptions from import duties have been offered to promote the inward transfer of new technologies. There have been non-tax incentives as well.

24. All this serves to illustrate that the recent crisis has not led to a strong backlash against FDI in Asia, quite the opposite, although it might be argued that sheer necessity has also played a role here. It is widely acknowledged that the stability of FDI, being long-term oriented and associated with more thorough risk assessment, contrasts favourably with the relative volatility of loans and portfolio investment. Foreign investment has propped up investment, as illustrated *e.g.* by the increase of the share of foreign investment in total equity investment in the Philippines: 52 per cent in 1998, as compared to 33 per cent on average in the five years before. This begs the question as to whether FDI should be welcomed, not only as a temporary stopgap, but as an important contributor to economic development. And, if this is so, how could the potential benefits of FDI liberalisation best be realised ?

The potential benefits of FDI, and how to realise them

25. In what way does FDI contribute to the local economy, or in other words, what are its spill-over effects, or backward linkages ? FDI has the potential of bringing in new production, employment, human capital and technology. It was observed that its role in the transfer of technology had been somewhat disappointing. In Thailand, for example, it was observed that it often relies heavily on the import of sophisticated imports, while there is little R&D-oriented investment. The main effect is at an operational level, in the form of on-the-job training. However, this is improving. One possible reason was that the spill-over effects tend to be higher among smaller investors, which have become more prominent recently, as noted. Furthermore, the role of FDI in stimulating capital formation and exports was acknowledged.

26. Liberalisation of FDI itself is not necessarily sufficient to realise the potential benefits of foreign investment. Policies need to be developed to ensure transparency in law enforcement, good corporate governance, proper accounting standards and disclosure rules, to promote institution building and the formation of human capital. The promotion of partnerships between foreign and local SMEs was also

mentioned as a point of attention. The absence of local financial and capital markets hampers FDI inflows, as was recognised *i.a.* in Vietnam. This leads to the next broad issue: the relationship between FDI and financial fragility.

FDI and financial fragility

27. It was generally appreciated that the liberalisation of foreign direct investment in the banking sector does not contribute to financial fragility. Opening of the financial markets as such cannot be held responsible for bank failures. On the contrary, absence of such liberalisation entails higher costs, slower institutional development and more fragile financial systems. The BIS Working Group on Strengthening Financial Systems was quoted as observing that a lack of well-developed money and capital markets is a root cause of banking crisis. The recent financial crisis in Asia was attributed to such inadequacies, notably to an insufficient supervision of market risks (e.g. credit risks as a result of insider lending and foreign exchange risks where assets were denominated in local currency and liabilities in dollars). Observing the 'Basle core principles,' strengthening of supervisory departments, more transparent financial disclosure and the training of mature bank inspectors were mentioned as points deserving attention.

28. The fact that foreign investment in the banking system may help strengthen the local financial system was underscored by the timing of the agreement on trade in financial services in the GATS context: this agreement was achieved in December 1997 and was made possible by the fact that countries affected by the crisis improved on their offers made (and rejected by the US) in 1995. Many of the offers reflected a standstill. While this could be helpful as a floor on which to build further commitments in subsequent rounds, it was also observed that actual legislation had moved beyond the commitments made in the GATS context. For example, ownership ceilings in several countries (the Philippines was mentioned as an example) are higher than the commitments by the same countries in the financial services agreement. Recent liberalisation measures have even widened this gap further. Why is this so: would it not give a positive signal for foreign investors if this further liberalisation were locked in by means of a multilateral agreement ?

29. This elicited the general question as to why there is so much apprehension about liberalisation of FDI in financial institutions in much of Asia, especially in light of the recognition that foreign investment can help strengthen financial systems. It was noted that banks are often seen as sensitive, or strategic sectors, which governments wish to keep in domestic hands for that reason. However, the point was also made that this sensitivity comes with a price tag: financial services are made more expensive. This is even more true in the long term, if distortions caused by protection of sectors have to be unwound.

30. This is not to say that liberalisation has to occur overnight, nor that instant benefits should be expected. Measures should be in place to ensure that FDI is indeed a source of stability. It was pointed out that the 1980s deregulation of the financial markets in Australia had led to a sharp expansion of credit, which was at the root of large loan losses when monetary conditions became tighter, as of 1988. It is important that proper regulation and effective supervision be in place. Liberalisation and domestic financial reforms should be a twin process. Reference was made to Chile, which escaped unscathed from the reverberations of the 'tequila' crisis in 1994/1995, because it had a strong and well-designed supervisory system. It was also noted that Chile had retained controls on short-term capital inflows. Nevertheless, Chile has been affected by the financial crisis, which ensued in Latin America in particular after the Russian defaults and which changed the risk perception of investors across the globe.

31. In summary, it was observed that liberalisation of FDI in the financial sector helps strengthening financial system. However, it is no substitute for adequate supervision and transparent disclosure rules, which should also be in place. Finally, there is a responsibility on the side of foreign lenders and portfolio investors as well: it is important that they actually pay attention to the warning signals that had been expressed about growing financial fragility in Asia before the crisis broke. Indeed, the recent crisis contains important lessons for all the main players.

Multilateral investment disciplines

32. It was proposed that a multilateral framework for investment could be of interest to developing countries, particularly the smaller ones that need FDI but that do not boast a large home market and whose bargaining position is weak vis-à-vis larger foreign investors could extract concessions. By “pooling sovereignty,” a downward competition for investment could be prevented. A multilateral framework could also act as a confidence-building factor for domestic investors.

33. Multilateral rules would be compatible with development strategies if they allowed for the ability to regulate economic activities on a non-discriminatory basis. As regards liberalisation, it would clearly be unrealistic to expect that all non-conforming measures should be rolled back equally rapidly by all parties. The level of development is an important factor in this regard.

34. A multilateral framework for investment could not have prevented a financial crisis such as the current one, but neither would it have prevented countries from taking measures to combat a crisis. The real problem lies in shortcomings in international co-operation and co-ordination on prudential regulation of financial institutions and financial markets.

35. It emerged from the discussion that there were different views on the desirability of a multilateral framework for investment and on its legal nature. Most Asian countries would, however, be open to a debate on the subject. Indonesia has a clear preference for non-binding disciplines such as exist within the APEC. Thailand and the Philippines are satisfied with the voluntary investment disciplines as envisaged with in APEC or ASEAN, but they are open to other initiatives. It emerged that, in spite of efforts by OECD countries to disseminate information, the MAI was not widely known in Asian countries.

36. From the perspective of India and China, the conclusion of bilateral agreements on investment protection and avoidance of double taxation, respectively, enjoys priority over any multilateral framework for investment. China interprets the APEC principles as binding. It is open to a debate on a multilateral framework. China would also seek assurances in such a framework that investors applied the same production standards as in the home country, particularly in the area of environmental protection.

37. The WTO appeared to many to be a logical forum in which to discuss multilateral investment disciplines. It should be stressed, however, that there is still no agreement to launch investment negotiations in the WTO, it remains unclear what such negotiations might produce and the proposed Millennium Round will take a long time.

38. It was emphasised that, within the OECD, consultations will continue to determine the elements of a multilateral framework for investment. This would allow the OECD to continue to make a substantial contribution that could attract broad support.

39. Participants from OECD countries emphasised that a multilateral framework for investment would could provide stability and legal security for investment. This would provide the sort of

transparency and predictability that investors seek. Such a framework was seen by some as providing as providing stronger guarantees than bilateral agreements that the rules for established investors are not changed unilaterally.

40. There was wide agreement that any multilateral framework should not prevent host countries from introducing or maintaining incentives for FDI. These incentives will differ according to the level of development and to financial and macro-economic conditions. On the question of taxation in relation to FDI, the OECD has introduced certain disciplines, such as the Guidelines on Transfer Pricing.

41. Participants agreed that the dialogue between the Asian countries and the OECD on a multilateral framework for investment should be continued. It was observed that UNCTAD had provided an important input into that debate, and its continued involvement would be welcomed.