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SOUTH-SOUTH INVESTMENT FLOWS - A POTENTIAL FOR DEVELOPING COUNTRY GOVERNMENTS TO TAP FOR SUPPLY CAPACITY BUILDING

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1. Introduction

Productive capacity is pivotal to any development strategy, and prerequisite to economic growth. The accumulation of investment requires harnessing domestic resources as well as mobilising foreign investment. If the overall policy environment is conducive and supportive, and assuming there is a vibrant entrepreneurial class, countries can build on foreign and domestic capital, enhancing competitiveness and productivity, speeding up technological upgrading, and integrating into the world economy through trade, via supply chains and through equity. Since foreign investment can be coupled with particular skills and technologies, or facilitate inroads into regional or global supply and marketing chains, policy makers in many developing countries are extremely interested in FDI and other inflows. Most countries now feature sophisticated investment promotion agencies designed to attract foreign investors. In fact, there is fierce competition among developing countries for FDI, notably since FDI flows have been stagnating since the early 2000s.

This makes South-South investment particularly attractive. Over the past decade, a noticeable dynamism in foreign investment has come from the developing countries themselves who are emerging as outward investors. This workshop will explore to what extent South-South can be a source for and stimulant in the creation of productive capacity.

It will examine three crucial areas with regard to South-South cooperation:

- South-South FDI trends;
- South-South investment flows: Policy measures and initiatives of developing countries
- A South-South cooperation framework

2. South-South FDI trends

During the 1990s, developing countries have emerged as sources of foreign investment. As Table 2.1 illustrates, there was a marked increase in outflows from developing countries across the board during the 1990s, with several countries emerging as outward investors. Recently, the surge in outward FDI from developing countries has evened out. This is due to an overlapping of a number of factors – political crises, economic recession, as well as the completion of structural change such as in the area of privatisation. Nevertheless, it is notable that several economies have firmly positioned themselves as outward investors, and it is likely that the others will re-emerge. Such countries include Malaysia, Singapore, the Republic of Korea and Hong Kong SAR, China. There are increasing investments in 2003 from Chile, Mexico and South Africa. Moreover, a take-off in investment is expected from Brazil, China and India.

This general trend towards rising South-South FDI flows has been motivated by a combination of push and pull factors, and similar structural, cyclical and policy factors. Some of the push factors include increased competition or limited growth opportunities in their domestic markets - e.g. South African retailing companies in Africa; efficiency-seeking FDI, such as Malaysian manufacturing companies investing in Indonesia and Viet Nam; or the procurement of raw materials, such as China's investments in iron ore and steel mills in Peru, or in oil in Angola and the Sudan. In addition to low labour costs and market-access opportunities, other pull factors for South-South FDI flows appear to be geographic proximity and ethnic and cultural ties. Since the cost of acquiring reliable information about foreign markets and transaction costs can be high for relatively small companies from the South, they tend to invest in neighbouring countries, where they have established a certain familiarity through trade, or ethnic and cultural ties. For example, perhaps because of ethnic ties, companies from the Republic of Korea invest in China and Kazakhstan, and ethnic Chinese companies invest in the East Asia and Pacific region.

Although there are no systematic data, there is anecdotal evidence that a relevant share of this FDI is invested in other developing countries. Some analysts suggest that at the end of the 1990s, more than one-third of the FDI in developing countries may have originated from other developing countries. According to these estimates, South-South FDI flows appear to have grown faster than FDI from high-income countries to developing countries (North-South FDI) in the late 1990s, and have remained relatively more resilient in the post-Asian-crisis period as well.

The trend in South-South FDI suggests that developing countries are more financially integrated with one another than was believed hitherto. This implies that a typical developing country has access to more sources of investment than before. This is particularly important for low-income economies, because TNCs from the South, because of their comparative advantages, tend to invest in countries with similar or lower levels of GDP than their home countries.

To get a more precise picture, it is of interest to examine at the enterprise level the actual FDI players. Within the group of the 50 largest non-financial TNCs from developing countries, Asian firms dominate with 31 enterprises. The largest corporations include Hutchison (Hong Kong, China), Singtel (Singapore) and Cemex (Mexico). The large developing country TNCs span a large range of activities, notably electronics (gradually declining in importance), food and beverages, and cement, signalling the export-competitiveness of the electronics industry, especially in Asia. The strength of food and beverages TNCs is related to market-seeking FDI, also led by Asia and also, to a lesser extent, Latin America. Some service industries feature prominently in the list, in particular transport, with many Asian firms benefiting from the region's rapidly expanding trade.

Table 2.1. FDI outflows from developing countries, by region, 1980–2003
(Billions of dollars)

Region/economy	FDI outflows (annual average) 1980-1989	1990-1994	1995-1999	2000-2003	FDI outward stock 1980	1990	1995	2000	2003
Developing countries	5.7	28.1	64.9	59.6	60.2	128.6	308.6	793.3	858.7
Africa	0.5	1.8	2.6	0.0	6.9	20.9	32.9	45.6	39.5
South Africa	0.2	0.7	1.9	- 0.6	5.7	15.0	23.3	32.3	24.2
Latin America and the Caribbean	0.9	4.7	18.0	10.6	46.9	58.8	86.3	155.5	183.8
Brazil	0.2	0.6	1.3	0.7	38.5	41.0	44.5	51.9	54.6
Chile	0.0	0.4	1.5	1.8	0.0	0.2	2.4	11.2	13.8
Mexico	0.1	0.4	0.7	1.9	0.0	1.1	2.6	7.5	13.8
Asia and the Pacific	4.3	21.6	44.3	49.0	6.5	48.9	189.5	592.3	635.4
South, East and South-East Asia	3.7	21.6	43.6	45.8	4.5	41.0	181.8	577.8	607.5
China	0.4	2.4	2.2	3.0	0.0	2.5	15.8	25.8	37.0
Hong Kong, China	1.2	10.5	22.5	23.0	0.1	11.9	78.8	388.4	336.1
India	0.0	0.0	0.1	1.0	0.0	0.0	0.3	1.9	5.1
Korea, Republic of	0.4	1.5	4.3	3.4	0.1	2.3	10.2	26.8	34.5
Malaysia	0.2	0.8	2.2	1.4	0.2	2.7	11.0	21.3	29.7
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World	93.3	234.8	603.1	779.3	559.6	1 758.2	2 897.6	5 983.3	8 196.9

Source: UNCTAD (www.unctad.org/fdistatistics).

3. South-South investment flows: Policy measures and initiatives of developing countries

In order to effectively attract this potential pool of inward FDI, developing country Governments and their investment promotion agencies (IPAs) are using a host of approaches and instruments. Many of these are similar to those applied in North-South investment promotion. The underlying principle of national treatment, found in many of the world's investment laws and international investment agreements, codifies that host governments shall, as a matter of law, treat investors of one country, whether developed or developing, the same as investors from any other country.

Most investment continues to take place between developed countries, according to the 2004 World Investment Report.[1] This is in part due to the fact that the larger transnational corporations (TNCs) are based in developed countries. The investment promotion and investor targeting strategies of many IPAs are therefore mainly focused on investors based in developed countries. Nevertheless, companies in many of the wealthier developing economies are increasingly becoming major foreign investors in their own right. IPAs in developing countries need to examine the means by which the increasing flow of investment between developing countries can be captured.

Several developing countries have in fact established outward investment agencies (OIAs). OIAs are institutions whose prime function is to promote and facilitate investment abroad by carrying out specific outward investment programmes.[2]

[1] UNCTAD, World Investment Report 2004.
[2] UNCTAD, Advisory Study No. 14, Handbook on Outward Investment Agencies and Institutions, UNCTAD/ITE/IIP/8 (1999).

OIAs are sometimes organized as part of an IPA. Examples include the Korea Trade-Investment Promotion Agency (KOTRA), the Malaysian Industrial Development Authority (MIDA) and the Mexican Investment Board (MIB). The primary objective of these agencies is to help domestic enterprises to develop business links abroad and to pursue overseas business opportunities. Activities of these entities include investment missions and conferences, as well as providing information on the political and economic conditions in foreign countries, regulations affecting investment, investment opportunities abroad and available financing.

OIAs in developing countries are not limited to those that are linked with IPAs. For example, institutions that provide development finance can also be considered as OIAs. Investment guarantees can also be considered outward investment promotion/facilitation. Development finance and investment guarantee institutions based in developing countries are particularly important for encouraging South-South investment as their programmes are geared more toward regions where the private sector may otherwise be reluctant to invest.

Development finance institutions seek to mobilize private capital for investment in developing countries and transitional economies by providing financing the form of loans, equity and grants for projects in these countries either in their entirety or in partnership with other investors. Examples of this include the Export-Import Bank of Thailand and the Development Bank of Southern Africa (DBSA), based in Midrand. Regional development banks, many of which are based in developing countries such as the Asian Development Bank and the African Development Bank, are also active in this area.

Investment guarantees are programmes that insure against risks (commercial and non-commercial) to encourage foreign investment and are especially important for investments in higher risk locations, including a number of developing countries. An example of an investment guarantee institution based in a developing country is the Islamic Corporation for the Insurance of Investment and Export, which was established in 1994 as a subsidiary of the Islamic Development Bank

A second means by which IPAs in developing economies could take advantage of the increasing investment potential between countries of the South is to tailor investment promotion and investor targeting strategies to encourage investment from other developing countries. Measures that lower the cost of entry could make it easier for firms in developing countries to invest in other developing countries (a Government could, for example, make incentives available to a wider spectrum of investors by lowering the minimum investment required to qualify). When elaborating investment promotion and investor targeting strategies for attracting investment from developed countries, it should be borne in mind those investments by major companies whose headquarters are based in a developed country can and do often use subsidiaries based in developing countries when investing in other developing countries. Strategies along these lines could also, for example, be elaborated around the concept of regional integration.

Finally, developing country IPAs can cooperate with each other and exchange best practices in attracting investment from other developing countries. Tools to encourage this include meetings where participants share their experiences, and participation of developing country IPAs in study tours to other IPAs involved in attracting investment from developing countries and/or to developing country IPAs involved in encouraging outward investment.

One organization encouraging such exchanges is the World Association of Investment Promotion Agencies (WAIPA). WAIPA was established in 1995 as a non-profit organization open to all agencies whose prime function is to promote any country or territory for investment, and its Secretariat is hosted by UNCTAD. Its annual conferences and its regional workshops are attended by the Association's global membership of 167 IPAs[3], and enable IPAs to share their respective experiences in the work of attracting investment. Many developing countries, particularly from Africa, the Caribbean and Pacific (ACP) countries, have taken advantage of WAIPA's study tour programme, where a majority of the hosting IPAs are also located in developing countries.

4) A South-South cooperation framework

The work of Investment Promotion Agencies (IPAs) and of Outward Investment Agencies (OIAs) needs to be underpinned by a cooperation framework conducive to South-South investment. It is hence encouraging to note that during the last decade, investment agreements between and among developing countries have increased substantially both in number and geographical coverage. This new wave of international investment agreements (IIAs) includes mainly bilateral investment agreements (BITs), and double taxation treaties (DTTs) as well as Preferential Free Trade and Investment Agreements (PTIAs).

Bilateral investment treaties (BITs)

Since the first BIT between two developing countries was signed in 1964, the number of South-South BITs reached 44 by 1990. Thereafter the number of South-South BITs more than quadrupled , reaching 653 by July 2004. This represents 28% of the total of 2,300 BITs in the world. In total, 113 developing countries have entered into BITs with another developing country to date, with China, Egypt and Malaysia signing more than 40 South-South BITs. In fact, these three countries have signed more agreements with other developing countries than with developed countries. In general, Asia – followed by Latin America – accounts for the largest part of South-South BITs. Statistical data further reveal that those countries with largest and fastest growing FDI outflows are those with the highest number of BITs, for example China, Malaysia and the Republic of Korea.

This phenomenon is occurring as developing countries are increasingly becoming home countries of FDI flows and their companies start to figure more prominently amongst the world's major transnational corporations. In fact, the outward FDI stock of developing countries has grown considerably since 1990, with a particular leap since 1995. In addition, FDI flows originating from and going to developing countries appear to be growing faster than those from developed to developing countries since the late 1990s. Thus, the South-South context is currently witnessing a parallel growth trend of South-South FDI flows and of South-South investment agreements that may be mutually reinforcing. Increasing FDI flows may provide an

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[3] as of November 2004.

impetus to protect and facilitate them by means of IIAs, while IIAs, in turn, may play a role in promoting more investment flows.

Some features are distinctive for South–South BITs. They tend to cover investment protection and promotion, refrain from explicitly prohibiting performance requirements, limit transparency requirements to the stage after the adoption of laws and regulations, and tend to put more emphasis on exceptions and on the so-called fork-in-the-road clause.

Double taxation treaties (DTTs)

A similar, though less pronounced trend is visible in the area of South-South investment cooperation in DTTs. Since the signing of the first DDT in 1956 between India and Sierra Leone, its number grew at a slow rate to reach 96 by 1990. During the 1990s then, 172 new DTTs were signed between 73 developing countries. The growth rate persisted until 2004 where 312 DTTs were entered between 94 developing countries. As a result, today 14 % of DTTs are amongst developing countries.

South-South DTTs are concluded throughout all geographical regions, but mainly in South-East Asia and to a lesser extent in Latin America and Africa. India, China and Malaysia accounted for the largest number of DTTs with other developing countries closely followed by other Asian countries while Tunisia stands out among the African and Arab countries. DTTs frequently go hand in hand with BITs to further improve the climate for FDI flows. More specifically, the years experiencing a relatively high increase in DTTs are also those with a relatively high increase in BITs. Interestingly, in the past, the cumulative number of South-South DTTs exceeded the respective number of South-South BITs, but since 1994 more BITs than DTTs exist between developing countries.

Due to the specific subject matter dealt with in DTTs, it is not surprising that no specific South-South features can be detected in the DTT universe. Noticeable, South-South DTTs do not uniformly include tax-sparing provisions, although these are deemed to be advantageous to the recipient country's FDI attractiveness.

Preferential trade and investment agreements (PTIAs)

Another important indicator for the rise in South-South cooperation in investment is the increase in Preferential Free Trade and Investment Agreements (PTIAs). Since the first South-South PTIA was signed in 1970 (between the Arab countries), its number grew rather slowly in the decade that followed. However, by 2004 the total number of PTIAs among developing countries reached 49. Today 31 % of all PTIAs are concluded among developing countries.

Amongst PTIAs, marked regional variations exist. Latin America and Asia are the most active regions with 25 and 14 PTIAs respectively, while Africa and the Middle East account for a smaller proportion. Moreover, African PTIAs are modest compared to the initiatives in Latin America and Asia. This regional distribution corresponds in part to the pattern of Southern outward FDI flows, albeit the ranking between Asia and Latin America differing in terms of FDI flows and PTIA memberships.

South-South PTIAs have been signed at bilateral and regional levels. Moreover, there are so-called "plus one agreements" which have been concluded between regional groups and additional individual countries. This approach is relatively common in Asia and Latin America. South-South PTIAs differ from BITs in terms of the depth and breadth of the investment issues covered. Some South-South PTIAs are rather modest in content because they establish frameworks for promoting FDI and mandates for future cooperation, rather than focusing on far-reaching liberalization and protection. However, they are still an expression of a broader spirit of South-South cooperation.

South-South IIAs also vary in terms of their substantive coverage. A number of South-South IIAs stop short of containing far-reaching substantive obligations, but rather establish frameworks for general principles in promoting investment and mandates for future cooperation. Other agreements are substantive in nature, including in as far as the development dimension is concerned. These include provisions on the establishment of an institutional framework, the granting of flexibility, the provision of technical assistance and capacity building, and the promotion of home country measures.

5) Questions and issues for discussion

The Workshop on Investment might like to address some of the following questions:

South-South investment flows

- How can recipient DCs utilise FDI from other developing countries in their supply capacity building?
- What are the main pull and push factors for South-South investment decisions? Is there a difference between FDI from developing countries and from developed countries? For instance, are there differences in terms of the motivation for FDI (market-, resource- or efficiency-seeking), industrial mix, in terms of capital intensity, technological know-how, employment generation, facilitating access to markets, and/ or in the transmission of managerial skills? What are the main obstacles to increased flows of investment between developing countries?

South-South investment promotion

- What are country experiences with a view to South-South trade and investment promotion?
- How can IPAs better target investment from subsidiaries and affiliates of TNCs based in other developing countries? Should IPAs consider creating departments devoted especially to attracting FDI from developing countries?
- To what extent is it feasible and useful for higher-income developing countries to establish Outward Investment Agencies?

A South-South cooperation framework

- What type of policy measures have proven useful to attract FDI from developing countries?
- What is the impact of changes in the international trade regime (example: phase out of the Agreement on Textiles and Clothing) on the choice of locations of developing countries' outward investment decisions?
- How can South-South investment agreements be tailored to specifically address the development dimension, and achieve economic developmental goals?