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Instruments to Boost EU Foreign Direct Investment to Developing Countries: Clearer Strategy and More Focus Needed

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The European Commission (EC) Communication calls for complementary instruments to boost FDI to developing countries. It argues that FDI has bypassed the 'countries most in need' and that the EU can help to improve the business environment through: (1) investment provisions in RTAs; (2) investor protection in bilateral investment agreements; and (3) schemes that blend loans and grants to 'support the financial viability of strategic investments'.

A number of issues need attention: (1) the three measures on their own are not enough to promote FDI – the question is how they fit in the overall picture; (2) this does not take into account developing country views on these measures; and (3) there is much more the EU can do to make engagement with the private sector more effective (what we call EU home country measures, see te Velde and Bilal, 2005). It is notable that the Council Conclusions on the Communication fail to mention FDI instruments at all.

Let us first consider the strategy behind promoting FDI. It is well known that there are a range of factors helping to promote FDI. These can be loosely divided into host country factors, home country factors and international factors (te Velde, 2007):

- **Host country factors** include market size and growth, economic fundamentals (skills, infrastructure), technology (strategic assets), natural resources (e.g. mineral resources), industrial (e.g. incentives, special economic zones, Special economic Zones (SEZs)), trade and macroeconomic policy and governance generally.

- **Home country factors** include support to economic fundamentals and governance structures in host countries (e.g. aid), support to reducing economic and political risks of investment projects, support to providing information surrounding investment projects (investor missions) and other policies that affect the viability of overseas investment projects, such as unilateral trade, tax, corporate social responsibility and corruption policies.

- **International agreements** include bilateral, regional and multilateral provisions on investment provisions.

The Communication focuses on only a small subset of measures without acknowledging the crucial importance of developing countries' growth and their fundamentals, policies and institutions in attracting FDI. If the objective is to promote more investment in developing countries, it is more efficient to pull rather than push it in. If the profitable project is not there, no amount of investor protection will lead to more FDI.

We should further mention that it is the quality of FDI that matters, not just the quantity. In fact, LICs as a group receive more FDI than others (when scaled for market size) (see Table). And what is the EU doing to make FDI work for development? Could it use home country measures to promote the development impact? Overall, the impact of FDI on development will depend on the type and strategy of investors, as well as host country conditions, policies and institutions. So, in short, it is important that FDI measures are part of a strategic framework behind both attracting FDI and making FDI work for development.

Second, the EU aims to use investment provisions in bilateral and regional investment treaties. Many bilateral investment treaties already exist, whereas small, vulnerable and poor countries have largely resisted signing investments in regional agreements (with the exception of the Caribbean). As such, it is not clear how much such provisions will be implemented; even where they are implemented, it is not clear how much they will help (the presence of investor protection might be seventh down the list of key factors behind FDI).

Finally, existing measures, including those mentioned in the Communication, are not sufficiently geared towards facilitating private investment. What actually is the interface between the EU and private investors? How does the EU work with investors? The blending mechanisms mentioned have until recently been used mostly for public sector projects (e.g. the EU–Africa Infrastructure Trust Fund, ITF), and are being accessed mostly by public sector financiers, such as the French Development Agency (Agence Française de Développement, AFD), KfW and the EIB, rather than private sector European development finance institutions (DFIs), such as DEG, Proparco and CDC, which are looking to finance sustainable and financially viable projects. For the EU blending schemes, we estimate that one unit of grants leverages in between five and six units of public sector loans (for both the ITF and the Neighbourhood Investment Facility, NIF) and another fifteen units of other finance. Thus, aid grants are likely to leverage in substantial amounts of other development finance, including for regional infrastructure as part of the ITF.

But in order to promote FDI, blending mechanisms need to be tailored more towards the needs of private sector while still promoting development. Grants and DFI finance can be used to leverage in private investment: DFIs are backed by implicit and explicit subsidies, and these can help to mobilise additional capital, including for infrastructure. Some $33 billion of DFI investment is invested in the private sector each year; around a third of this goes to infrastructure. Every dollar of CDC investment coincides with $5 of other investment; every International Finance Corporation (IFC) dollar leverages about $3 from others; every European Bank for Reconstruction and Development (EBRD) dollar leverages in another $1. Massa and te Velde (2011) find that private sector DFIs do leverage in investment and growth in the macro sense: a one percentage point increase in DFI investment as a percent of Gross Domestic product (GDP) leads to a 0.8 percentage point change in the investment to GDP ratio. The authors (2011) argue that the international community should scale up project preparation funds, especially for large infrastructure projects, and leverage in private investors and sovereign wealth funds, as also emphasised by the the Group of 20 (G20) high-level panel on infrastructure. The EU could also consider this.

Importance of exports, FDI and remittances by country group, 1970-2010 (% of GDP)

	1970	1980	1990	2000	2008	2010
Exports of goods and services						
LICs	12.7	13.2	11.9	17.5	21.4	19.7
MICs	9.6	15.4	19.1	27.3	32.1	28.5
OECD members	12.7	17.5	17.4	22.2	25.9	24.9
Sub-Saharan Africa	21.8	31.9	26.4	32.4	35.9	29.7
East Asia and Pacific	7.7	16.9	22.3	35.3	42.3	37.2
Latin America and Caribbean	10.0	13.2	17.0	20.0	23.8	22.3
FDI, net inflows						
LICs		0.4	0.3	1.5	3.2	3.4
MICs		0.6	0.7	2.6	3.7	2.6
OECD members	0.5	0.6	1.0	5.4	2.7	1.6
Sub-Saharan Africa	1.3	0.1	0.3	2.0	3.7	2.5
East Asia and Pacific			1.6	2.6	3.7	3.0
Latin America and Caribbean	0.4	0.8	0.7	3.8	3.0	2.3
Workers' remittances and compensation of employees, received						
LICs		1.5	1.7	3.2	8.1	7.2
MICs			1.1	1.3	1.8	1.6
OECD members		0.3	0.3	0.3	0.4	0.3
Sub-Saharan Africa		0.6	0.7	1.6	2.3	2.2
East Asia and Pacific			0.5	0.9	1.5	1.2
Latin America and Caribbean		0.3	0.5	1.0	1.5	1.2

Source: World Development Indicators.

References

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