Working Paper
The role of foreign direct investment (FDI) in international capital flows is examined. Theories of the determinants of FDI are surveyed, and the economic consequences of FDI for both host (recipient) and home (investor) nations are examined in light of empirical studies. Policy issues surrounding possible negotiation of a "multilateral agreement on investment" are discussed.

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* Edward M. Graham prepared this study as a visiting scholar in the Research Department. He is an economist at the Institute for International Economics, Washington, D.C.
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Summary

Foreign direct investment surged during the 1980s as firms from many nations expanded their international operations. This paper surveys a number of aspects of foreign direct investment and its role in the "globalized" world economy. The precise nature of foreign direct investment is examined from both microeconomic and macroeconomic perspectives. Historic patterns of foreign direct investment are explored, with emphasis on the large surge that took place following 1985. The (correct) proposition that foreign direct investment is not synonymous with international transfer of capital is analyzed from both a theoretical and empirical perspective.

Key characteristics of foreign direct investment and the multinational corporations that generate it are examined in detail. These include the determinants of foreign direct investment and the international expansion of firms as best as they are understood. Also analyzed are the relationships between foreign direct investment and capital formation, technology transfer, international trade, and the economic growth of both host (recipient) and home (investor) nations.

The paper concludes by surveying the policy issues that figure in current efforts to put international direct investment under the aegis of the multilateral trading rules. It is likely that in the near future some sort of "multilateral agreement on investment" will be negotiated. Issues of both substance and venue (that is, the question of whether the agreement will be negotiated within the World Trade Organization or some other negotiating body) are discussed.
I. Introduction

Worldwide flows of foreign direct investment (FDI) began to surge about ten years ago. In the year 1984, the total flow of direct investment outward from the industrial economies (which accounted for the vast majority of total measured flows worldwide) was a substantial $49.5 billion. Subsequently, FDI flows steadily increased each year until they peaked in 1990 at $222 billion, more than quadruple the flow of 1984. Following the 1990 peak, annual flows of FDI attenuated somewhat but remained at high levels ($178 billion in 1991, $162 billion in 1992, and $175 billion in 1993).

FDI flow is, by definition, an increase in the book value of the net worth of investments in one country held by investors of another country, where the investments are under the managerial control of the investors. Most of these investments are, in fact, subsidiaries of multinational corporations (MNCs) and the investors are the parent organizations of these firms. Thus, FDI flows mainly represent the expansion of the international activities of MNCs. The FDI surge that began in the mid 1980s therefore is largely a manifestation of the much discussed "globalization" of business that has taken place during the past ten years.

This paper discusses a number of facets of FDI. First, the precise nature of foreign direct investment is examined in some detail from a macroeconomic and microeconomic perspective. Some long-term trends--where "long-term" means approximately one century--are discussed, as best as these trends can be identified given data limitations, with a special emphasis on the surge identified above. Some characteristics of FDI--and of the MNCs which generate it--are analyzed, including (1) the determinants of FDI as best as they are known (we shall see that the theory of FDI is not wholly satisfactory), (2) the effects of FDI on host (recipient) nations, including effects on economic growth, and (3) the effects on home (investor) nations. The paper concludes by discussing some of the current policy issues posed by FDI and the globalization of business.

II. What is FDI?

The first thing that should be said about foreign direct investment is that the term is a misnomer. FDI is not, in either an accounting sense, whether one is talking of financial accounting or of balance of payments accounting, or in an economic sense, truly "investment". For accounting purposes, FDI takes place when the book value of the net worth of an investment controlled by investors in a country other than the country in
which the investment is legally domiciled increases. 1/ As noted above, in most cases the "investment" is in fact a subsidiary of a MNC. 2/ The subsidiary itself is typically an ongoing business under the managerial control of the parent firm. On the balance sheet of the subsidiary, the subsidiary's net worth is simply the value of assets of the business minus the liabilities owed to entities other than the business's owners; by the fundamental financial accounting identity

\[ (\text{assets}) = (\text{liabilities}) + (\text{owner's equity}) \]

the net worth must be equal to the book value of owner's equity, which in turn consists of paid-in capital of the owner plus retained earnings. 3/

Thus, from a balance of payments perspective, foreign direct investment from one nation to another consists (mostly) of any net increases in the paid in capital of investors in the first nation to their subsidiaries domiciled in the second nation plus any increase in the retained earnings of these subsidiaries. These increases are recorded in the long-term capital

1/ If, as can happen, the investment is jointly owned by foreign and domestic investors, then FDI corresponds only to the increase in the value of the portion of the net worth attributable to the foreign investor, including the value of any change in that portion occasioned by transfer of ownership. Thus, if an on-going firm in some nation originally under domestic ownership is sold to a foreign investor, the price paid by the foreign investor to acquire the firm is counted as FDI (this price representing, from the new owner's perspective, the value of its equity in the firm).

2/ We must say "in most cases" because there are international capital flows that are classified as FDI that do not involve transactions between multinational parent firms and their overseas subsidiaries, e.g., purchases of residential real estate by individuals and real estate holdings by investment trusts. Worldwide, such transactions account for less than 5% of the total stock of FDI. Such transactions probably would be better classified in a separate category from FDI but, at present, this is not done.

3/ IMF standards thus treat FDI flows as the sum of paid in capital and retained earnings. There are substantial differences, alas, in accounting standards for FDI from country to country, and not all countries follow IMF guidelines. Some countries, e.g., the United States, consider any loans from the parent to the subsidiary to be paid-in capital (and, likewise, any loans from the subsidiary to the parent to be negative paid-in capital), but this practice is not universal. Not all countries count retained earnings as FDI flows, e.g., Japan does not. There are substantial differences among countries definitions of what constitutes financial control which results in some countries counting as FDI investments that other countries would consider to be long term portfolio investments; for this reason, as well as for reasons of errors and omissions, total measured FDI flows outward from home countries do not equal total measured flows into host countries.
accounts of the two nations as a long-term capital outflow of the investors' nation and as a long-term capital inflow of the subsidiaries' nation. To count increases in retained earnings thusly might appear a bit odd, as no transaction actually takes place between the two nations. The dilemma is resolved by balance of payments accountants under IMF standards by considering all earnings reported by the subsidiary (whether retained by the subsidiary or repatriated to the parent) as being transferred to the investors in the home country (remember that in almost all cases, the "investor" is in fact the parent organization of an MNC). The portion of these earnings retained in the subsidiary is then classified as a long-term capital flow back to the host country.

From the perspective of a subsidiary, then, FDI is a source of funds and not a use of funds. Furthermore, it is but one possible such source. Others include borrowing from local or international lenders other than the subsidiary's foreign owners and raising equity capital from local minority shareholders if the foreign parent does not hold 100 percent ownership. Capital expenditures of the subsidiary, which correspond roughly to the economists' concept of real investment, are uses of funds. It follows that FDI flows do not necessarily correspond to real capital formation generated by subsidiaries of MNCs. 1/

Indeed, there may be no correspondence whatsoever. Consider two polar cases. In the first, an MNC acquires an ongoing firm in a country other than its home country, paying the current owners of that firm cash. In the year that this transaction takes place, the acquired firm engages in no capital investment whatsoever. The transaction represents a direct investment, but no economic investment takes place. In the second, a subsidiary already under the control of an MNC embarks upon a large capital expansion program but reports zero earnings and zero dividends in that same year and no change takes place in the parent firm's paid-in capital; the capital expansion thus is financed via borrowing from financial lenders. No direct investment between the home and host countries is attributable to this parent/subsidiary pair, but the subsidiary has contributed to real capital formation in the host country.

An interesting question then is, how much of a discrepancy is there between measured FDI flows and economic investment? Unfortunately, global data do not exist that would enable this question to be answered. The question can be answered with respect to U.S. outward investment, because

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1/ Economists also include as investment any net change in the value of inventory. In what follows, this component of investment is ignored. The effect is the same if we simply assume that there is no net change in inventory. Also, of course, any capital that is used up during the course of a year (measured as depreciation) is, from an economic point of view, equivalent to disinvestment. In the discussion that follows, the term "investment" can be taken to mean either gross investment, i.e., investment before depreciation, or net investment, i.e., investment after depreciation.
the U.S. government does keep data on the new capital expenditures of majority-owned overseas subsidiaries of U.S. firms (Chart 1).

It is immediately apparent from Chart 1 that capital expenditures of majority-owned affiliates of U.S. firms have consistently been greater than outflows of direct investment from the United States. That is, direct investment from the United States significantly understates the economic investment worldwide (outside of the United States) of U.S.-based MNCs. 1/

Would a similar statement hold for direct investment from other industrial nations? The answer is "probably not" because of vintage effects specific to direct investment of the United States: the average age of foreign affiliates of U.S. firms is somewhat greater than that of foreign affiliates of MNCs from other nations, and hence the contribution of retained earnings to U.S. direct investment outflows likely is higher than for other nations. (We say "likely" because data limitations prevent testing of whether this last statement is really true.)

Chart 1 also suggests that new capital expenditures of majority owned subsidiaries of U.S. firms do not move in lock step with outflows of U.S. direct investment. 2/ The likely reasons for the discrepancies are that (1) U.S. outward investment is, as already suggested, only one source of financing of the capital expenditures of foreign subsidiaries of U.S.-based firms (2) the mix of financing is sensitive to such variables as interest rates in differing capital markets and other financial factors. Thus, following 1979, when U.S. interest rates rose relative to those elsewhere, the ratio of capital expenditures by these subsidiaries to U.S. outward direct investment fell sharply, indicating that these subsidiaries were turning to other sources of finance. Indeed, the sharp drop in U.S. direct investment abroad during the early 1980s was likely caused in part by U.S. firms borrowing funds or receiving dividends from their foreign subsidiaries in response to very high costs of raising financial capital within the United States.

All of this simply reaffirms the opening sentence of this section to the effect that the term "foreign direct investment" is a misnomer. Indeed, from a national income perspective as well as from the perspective of a firm, foreign direct investment is also a source of resources for investment

1/ Indeed, the extent of the understatement is probably itself understated by the data on Chart 1, because these data do not account for the capital expenditures of non-majority owned subsidiaries of US firms.

2/ A simple regression of the two variables of the chart on each other yields a statistically significant regression coefficient ($\beta$) of 0.81 with an adjusted $R^2$ of 0.42, not a very good fit for a time series of two variables that one might expect to move in lockstep. (If the two variables did move in lockstep, one would expect the regression coefficient and the $R^2$ to be unitary.) Also, the intercept ($a$) term is significantly different from zero, indicating that the levels of the two variables are not the same.

- Capital Expenditures by Foreign Majority Owned Affiliates
- US Direct Investment Abroad
(where net outward direct investment implies a depletion of these resources) rather than investment itself. This is evident from the national income identity \( I = S - \Delta A_I \), where \( I \) is gross domestic investment, \( S \) is gross domestic savings, and \( \Delta A_I \) is net change in the international assets held by domestic residents (including official reserves), and noting that \(-\Delta A_I = X - M\), where \( X \) equals exports and \( M \) equals imports. 1/ FDI is just one component of \( \Delta A_I \) and an increase in inward direct investment does not automatically imply an increase in \( I \) nor does outward direct investment imply an automatic decrease in \( I \). We have already shown that in some cases there can be no effect. For example, in the first case above, the acquisition of a domestic firm by a foreign one, the inward direct investment flow generates a decrease in \( \Delta A_I \) (implying an increase in funds available for domestic investment). But this is exactly offset by claims by domestic residents on foreigners, because the original owners of the acquired firm now hold some claim on the new owners (and this shows up in the income identity as an offsetting increase in some other component of \( \Delta A_I \)).

Thus, we have defined what FDI is in this section, with an emphasis on what it isn't. But this is far from the end of the story. If FDI were nothing more than an international transfer of financial capital, we would in fact be close to the end of the story. But FDI, being a measurable manifestation of the international spread of MNCs, entails much more than a financial transfer. Associated with FDI is transfer of technology and other so-called "intangible assets", the stuff of which long-term economic growth is largely made. We shall examine these transfers, and why they take place, shortly. Before doing so, let us look at some historic facts about FDI.

III. FDI in the Long Reach of History

An unfortunate fact is that very little data pertaining to FDI exist for the years prior to World War II and much of what data do exist are unreliable. Nonetheless, economic historians have been able to build a convincing case that FDI—and MNCs—played important roles in economic development at least as far back as the industrial revolution of the late 19th century. Indeed, the history of FDI goes back even further—the East India Company, from virtually its start an MNC, was chartered in London in 1600—but little analysis of its role has been attempted.

During the late 19th and early 20th centuries, large amounts of long-term financial capital flowed across national boundaries, financing projects as diverse as the building of the railroads that opened the American West and the construction of great tea plantations on the Indian subcontinent. Fairly reliable records of these flows exist, but it is difficult to say how much of them represented direct investment. In a pioneering study published in 1936, Cleona Lewis, working mostly with U.S. data, estimated that the

1/ International transfers are ignored in this treatment.
vast bulk of the flows represented portfolio, rather than direct, investment, and this was accepted as fact for about four decade (Lewis 1938). However, beginning in the middle 1970s, a number of economic historians have perused in fine detail the international accounts of the United Kingdom, by far the largest international investor nation of the period, and concluded that at least a third and perhaps more of stock of the U.K.'s overseas investments were direct in 1914. 1/ Studies of other European nations’ accounts have yielded similar results. 2/ By the first decade of this century, significant numbers of U.S. direct investors were active in Europe and European direct investors were active in North America, and a number of what are today's largest MNCs from both continents can trace their first international business activities to this era. 3/ This "north-north" FDI covered a spectrum of sectors, including petroleum and other natural resource-based industries, manufacturing, and services, especially transport (e.g., railroads) and financial services (e.g., insurance).

However, the bulk of FDI early in this century was north-south in nature, i.e., the home nations were those of Europe, the United States, Canada, and Japan and the host nations were the less developed nations of Asia, Africa, and Latin America. This north-south FDI was heavily concentrated in resource-based industries and in transport and utilities. Thus, it is estimated that in 1914 the shares of British outward direct investment of these two sectors were 53 percent and 31 percent respectively, and that the share of both sectors combined of U.S. outward FDI was 68 percent with manufacturing accounting for another 18 percent. 4/

World War I put a brake on the international expansion of MNCs and, indeed, international business activity as a percentage of all economic activity almost surely shrank in the interwar years 1918-38 (but, again, data limitations prevent full exploration of this issue). However, during these years, some sectors witnessed large amounts of new direct investment. These included manufacturing (this was the period, for example, when Ford and General Motors established operations in Europe, Latin America, and Asia) and, most especially, petroleum, this latter seeing enormous expansion in Latin America (especially Venezuela) and the Middle East. During the Great Depression years of the 1930s in particular, there was very little expansion of the international activity of MNCs (and, in some sectors and regions, this activity contracted), with the exception of those in the petroleum industry.

FDI picked up sharply after World War II, especially after 1960. U.S.-based firms in the manufacturing sector especially expanded their international activities. Most of this expansion was focused on developed

1/ The pioneering study in this regard is Houston and Dunning 1976.
2/ For a review, see Jones 1994.
nations, especially those of Europe where U.S. firms sought to establish local subsidiaries in response to the formation of the European Common Market, now the European Union (EU). As a result, between 1950 and 1970, the stock of U.S. manufacturing direct investment in Europe increased almost fifteen fold, while the share of the stock of U.S. FDI in developing countries declined to less than 40 percent in 1970. By this year the share of the stock of U.S. outward FDI in manufacturing had grown to 41 percent.

In 1970, total flows of FDI on an outward basis as reported in IMF statistics were slightly less than $13 billion, flows from the United States were about $7.5 billion or about 60 percent of the total, and flows from the seven largest industrial countries (the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada) were a bit less than $12 billion or about 91 percent of the total. FDI flows from all of the industrialized nations equalled over 99 percent of the total. International data on FDI for years prior to 1970 are incomplete, but it is probable that the U.S. share of total FDI flows throughout the period 1950-1970 was well over 60 percent.

IV. Recent Trends in FDI

By 1993, of the reported total outward FDI flow of over $186 billion, the U.S. share had fallen to 31 percent, the seven largest industrial nations' share to 79 percent, and the share of all industrialized nations to 94 percent. Of the 6 percent share that was not accounted for by industrial nations, the majority (3.5 percent of the total) was accounted for by Asian nations and the remainder was spread over a number of developing nations (including but not limited to several of the major oil exporters).

Chart 2 indicates flows of FDI from the seven largest industrial countries from 1970-1993, with flows from the United States and the remaining six nations separately indicated. 1/ Several features stand out. First, the U.S. share of these flows was 50 percent or more from 1967 to 1972 to 1979. After 1979, however, the U.S. share began to fall, reaching a low of just over 17 percent in 1990, the year of peak flows worldwide. Following 1990, however, the U.S. share rebounded sharply, reaching over 39 percent in 1993, a phenomenon examined in more detail below.

Second, total flows of FDI from the seven largest industrial nations experienced a "minisurge" during the late 1970s and early 1980s but fell sharply following 1981. From the trough year of 1982 onward, however, FDI flows increased steadily, and the growth became spectacular following 1985 until, as noted in the introduction, these flows peaked in 1990. Exactly

1/ In this and subsequent charts, FDI outflows are given positive (+) sign; this is in contrast to normal balance of payments reporting, wherein capital outflows are signed negative (-) and inflows positive (+).
what caused this surge of FDI growth is not entirely clear. If the magnitude of the 1985-1990 surge is ignored, the trends in FDI flows from the seven largest industrial nations during the past twenty five years or so correlate quite closely with trends in national income growth (that is, these flows seem to wax and wane more or less contemporaneously with first differences in annual income), but the income elasticity of FDI flow appears to be highly nonstationary. 1/

What is most clear about the 1985-90 FDI surge is that by a number of measures, FDI became more diversified during this period. As already noted, the predominance of the seven largest industrial nations and, within this group, the predominance of the United States as home nations to FDI decreased. The sectoral diversity of FDI increased; in particular, the amount of FDI in the service sectors rose sharply relative to manufacturing. 2/ However, by certain other measures, FDI became less diversified. In particular, the share of FDI flows going to the industrial countries actually increased during the 1980s and, correspondingly, the share going to the developing countries fell.

Indeed, one of the most notable features of the period was the share of FDI received by the United States, which became the largest host country as well as the largest home country to FDI. Chart 3 traces the cumulative stocks of FDI in the United States (FDIUS) as well as the stocks of U.S. direct investment abroad (USDIA) from 1970 to 1993. Whereas in 1970 the stock of FDIUS ($13.3 billion) was only 17 1/2 percent of that of USDIA ($75 1/2 billion), in 1989 the stock of the former ($369 billion) was 96 1/2 percent that of the latter ($382 billion). Whereas foreign controlled business operations accounted for a negligible portion of U.S. economic activity in 1970, they grew to account for a very substantial portion by 1989. 3/

But from 1989 to 1993, USDIA grew much faster than FDIUS, so that by the end of 1993 the stock of the former ($445 1/2 billion) was now only 81 percent of that of the latter ($548 billion). What happened? The first thing to be noted is that some aspects of the trends are more apparent than real; in particular, USDIA data have been affected by recalibrations periodically made by the U.S. Department of Commerce (e.g., the drop in the stock of USDIA shown in Chart 3 as occurring in 1981 was largely the result of such an adjustment, rather than actual disinvestment by U.S. firms).

Chart 4 indicates the U.S. flows of outward FDI from 1982 through 1992 broken down by major component: New equity, retained earnings, intrafirm debt, and valuation adjustments. 4/ Several points emerge from the rather confusing picture posed by the chart. First, U.S. firms largely were absent

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1/ For more on the surge of 1985-1990, see Graham and Krugman 1993.
4/ Alas, this breakdown is not available for years prior to 1982.
Chart 2: FDI Flows from the G7 Nations 1967-1993

- total FDI flow from G7
- FDI from US
- FDI from non-US G7
Chart 3: Stocks of Direct Investment in the US and US Direct Investment Abroad 1970-93
Chart 4: Composition of Flows of US Direct Investment Abroad
1982-1993
from the FDI surge of the mid to late 1980s (new equity flows were a trickle in the years 1983-1990 and, indeed, there was net disinvestment in 1985, 1988, and 1989), but new equity flows accelerated sharply following 1990). Second, intrafirm debt flows were negative during the U.S. high interest years of 1982-84, lending credence to the earlier hypothesis that low U.S. FDI outflows in those years were in part a result of interest rate differentials. Third, retained earnings were strongly positive throughout most of the period. Fourth, valuation adjustments were significant (and, because these are largely generated by currency fluctuations, the effect of adding valuation adjustments to reported FDI flows is probably to mislead slightly the analyst who does not take these into account).

V. The Determinants of FDI

Over the years there have been many efforts to explain why firms engage in FDI. Perhaps the place to start is to note that in a world of perfect competition, most FDI simply would not occur, because MNCs would incur transactions costs not incurred by their domestic rivals and these costs would drive returns to subnormal levels. It should be emphasized as well that FDI is not simply an international flow of financial capital as might occur if arms' length investors in capital-rich countries simply sought higher returns in capital scarce countries: while such flow does occur, it is in the form of portfolio investment rather than direct investment. Given these considerations, analysts have largely looked to the internal characteristics of MNCs in order to explain FDI.

One of the earliest studies was by John Dunning, who examined the operations of British affiliates of U.S.-based MNCs relative to the British-owned rivals of these affiliates (Dunning 1958). He found that the U.S.-owned affiliates were more productive than their local rivals, a fact that Dunning ascribed to the abilities of the former to transfer technologies and other "intangible assets" (e.g., marketing and other managerial skills) from the U.S.-based parent firms to the United Kingdom and to adapt these to the British environment. But also, over time, the British firms caught up with their U.S.-owned rivals, leading Dunning to conclude that the overall effect of U.S. FDI was to raise British levels of productivity in all firms in an industry, generating net benefits for the British economy. Dunning's enthusiasm for FDI in the United Kingdom almost forty years ago is mirrored in the enthusiasm of many countries today.

A second pioneering study of the same epoch by Stephen Hymer explored the nature of internal characteristics of MNCs that enabled them to engage in FDI, identified as "economies of scale" and "special management skills". Hymer was gloomier than Dunning is his assessment of MNCs; he argued that by while these firms were likely to be more efficient than their rivals, they would also gain market power so that the benefits of competition were lost, with the latter dominating the former benefits. This last concern in fact came to dominate a wide ranging debate on the merits of the MNC during the 1970s. At that time, it was very much in fashion, especially in developing
nations, to view MNCs as powerful, monopolistic institutions that would corrupt governments and reduce host nation welfare. 1/ As a consequence, policies proliferated in the 1970s to restrict inward FDI and regulate closely the activities of MNCs. Such policies were mostly implemented by developing nations but, also, by some industrial nations such as Canada.

Some analysts, while also starting from Hymer's analysis, arrived at quite different conclusions. In a series of influential articles and books, Raymond Vernon emphasized the importance of new product technology as a determinant both of international trade and investment and the role of factors specific to the home markets of firms as a determinant of how this technology gets created and diffused (Vernon 1966, 1971a, and 1971b). Taking a somewhat different tack, Peter Buckley and Mark Casson noted that international exploitation of firm-specific advantages internationally does not require that a firm actually own and manage international operations (Buckley and Casson 1976). Rather, the advantages could exploited via export or licensing agreements with firms based in nations outside the home market (as, for example, many MNCs struck with Japanese firms during the 1960s and 1970s, when Japan severely restricted FDI inflows). Thus, to explain why operations in one nation are actually owned and managed by a firm in some other nation, Buckley and Casson turned to the organizational theory of the firm, as originally developed by Ronald Coase and expanded by Oliver Williamson (Coase 1937; Williamson 1975). According to these authors, there are economies to be realized by internalizing within a single organization production and marketing functions. These economies of internalization result, in essence, from firms' efforts to avoid the high transactions costs that are associated with attempting to achieve similar outcomes through buying and selling services in external markets. Such transactions costs include opportunity and moral hazard costs. If such economies can continue to be realized by expanding the organization to cross national boundaries, then FDI occurs.

Buckley and Casson triggered a number of subsequent studies applying the organizational theory of the firm (a theory that itself has seen considerable refinement in recent years) to the MNC. 2/ For example, John Cantwell posits that rivalry among MNCs leads to more rapid development and diffusion of desirable new technologies than would occur in a world where there were no economies of internalization and where technology was transferred by licensing (Cantwell 1989). This suggests that FDI is positive in terms of effect on economic efficiency and growth, the conclusion first reached by Dunning. In the following sections some of the logic and evidence for this position is examined from the perspective of both home and host nations.

1/ See, e.g., Barnet and Mueller 1974, which was for a time a best seller in the United States.
2/ A comprehensive review is found in Dunning 1993, Chapter 4.
Before moving to this examination, however, it should be noted that there are aspects of FDI and the MNC not adequately explained by Buckley and Casson and subsequent theories based on the organizational theory of the firm. In particular, these theories cannot explain why FDI has undergone surges. There are economic theories of the determinants of FDI and the MNC not based on the organizational theory of the firm, e.g., ones based on the dynamics of oligopoly and on new theories of economic geography, that have some explanatory power. For reasons of space, these are not reviewed here. 1/ For the moment, however, most analysts agree that explanations of FDI based on the organizational theory of the firm have more power than other genres of theory. 2/

VI. The Economic Consequences of FDI for Host Countries

FDI and MNCs can have both positive and negative economic effects on host countries. Positive effects come about largely through transfer of technology and other intangible assets, leading to productivity increases that improve the efficiency of resource utilization and ultimately lead to higher per capita income. As has already been suggested, such effects can be direct, e.g., if subsidiaries of MNCs are more productive than local rivals, or if they transfer technologies or other assets to local suppliers, distributors, or other firms with which the MNCs do business and, by doing so, enhance the productivity of these. But these effects can also come about indirectly, e.g., if increased interfirm rivalry engendered within a sector by entry by MNCs leads to all firms in that sector becoming more productive. "External benefits" associated with MNCs can also boost productivity. For example, an MNC might employ local workers (including at technical and managerial levels) who, as a result of this employment, upgrade their own knowledge and skills and subsequently leave the MNC and become employed elsewhere. To the extent that their new knowledge and skills can be utilized in their new positions, such knowledge and skills must be counted as external benefits associated with the MNC, i.e., benefits that are captured neither by the MNC itself nor the users of its products or services. Both direct benefits brought about between linkages between MNCs and local firms (e.g., suppliers and distributors) and indirect benefits, whether created via increased rivalry or via the generation of external benefits, are typically termed "spillover effects."

Negative economic effects can also be both direct and indirect. Direct negative effects, from a purely economic perspective, can arise from the market power of the MNC and the ability of an MNC to use this power to generate supranormal profits and transfer these to its shareholders, who presumably are not residents of the host country. In addition to negative economic effects, the MNC might be capable of indirectly creating negative economic effects for the host country. For example, MNCs might be able to

1/ For a review, see Onida 1989.
2/ See, e.g., Graham and Krugman 1995 op. cit.
influence the local political process to the economic detriment of the host nation's economy (e.g., by inducing politicians to grant to the MNC direct or indirect subsidies such as investment incentives or protection from imports in the local market).

There is no reason why, in principle, the positive effects should be dominated by the negative effects or vice versa. This indeterminacy is, perhaps, why debate over the MNC has long been lively and subject to "sea change". As was suggested in the previous section, it was the fashion during the 1970s, especially in developing countries, to view the negative effects as dominant, whereas in most of those countries today the positive effects are largely viewed as dominant. Interestingly, in the case of the United States, where official policy had been to stress the positive aspects of FDI throughout the 1960s, and 1970s, when FDI into the United States began rapidly to rise during the late 1980s, many politicians began to question the benefits of this influx and some restrictive measures have been passed. 1/ Thus, to an extent, trends in official policy of the United States have moved against the overall world trend.

Given that, in principle, the economic effects of FDI can be in net positive or negative, the issue becomes an empirical one: as events actually transpire, which effects dominate? The first thing to be said on this issue is that it is truly difficult to measure the effects of FDI and MNCs. Does participation by MNCs, for example, increase or decrease firm concentration in the affected industries? Several points to be made in this regard are: (1) there is an association between global industry concentration and participation by MNCs, but the correlation is not exact (the "R^2" is far from 1.0); 2/ (2) however, over time, the trends in industry concentration have been nonuniform; generally, concentration in industries with heavy MNC participation fell from 1962-82 3/ but rose in the later 1980s; (3) at the level of individual countries, the trend in most such industries over the last twenty years has been for concentration to rise. 4/

However, as has been noted by numerous analysts, a rise in industry concentration does not necessarily imply an increase in monopoly power within an industry, especially at the level of individual countries. Effective competition within a country might actually be negatively correlated with domestic industrial concentration. If, for example, the concentration were to be the consequence of an opening of the country to international competition followed by rationalization of the domestic industry to become more efficient, domestic industrial concentration could rise even though effective competition certainly increased. Likewise, it must be pointed out that a fall in industry concentration does not

4/ Individual studies are reviewed in Dunning 1993, op. cit.
necessarily imply a reduction in monopoly power; if, for example, within an industry, there were to be a trend towards greater differentiation of products that were imperfect substitutes, individual product varieties might be increasingly produced by just one or a small number of firms that monopolize individual market segments. Whether overall competition were to be effectively rising or falling would then depend upon the degree of inter-variety competition.

In a word, while there is some information to be had in the study of firm concentration, ultimately it does not shed much light on whether MNCs do or do not achieve monopoly rents in host nations. To determine this, one might think that studies of firm profitability would be fruitful. But this route too leads to indeterminant results. This is particularly true if one seeks to investigate the profitability of MNCs' operations in individual host nations: because MNCs can (and apparently do) use transfer prices in order to shift reported profits from one locale to another (largely for reasons of tax minimization), it is impossibly difficult to determine what really is the return of the MNC in any particular location. 1/ But even if one looks to the worldwide profitability of MNCs, one must adjust for such variables as differences in intensity of factor usage (MNCs, over a range of industries, tend to be more capital intensive in their factor utilization than do non-multinational rivals, and hence the former might be expected to report higher profit rates than the latter). Of the many studies of MNC profitability, the weight of the evidence seems to be that these firms are marginally more profitable than their non-multinational rivals, but that the difference largely disappears (or becomes statistically insignificant) when factor intensity is controlled for.

Thus, the evidence on the existence, let alone the magnitude, of negative economic consequences of FDI and MNCs is inconclusive but tending towards dismissal that these consequences are weighty. What about the evidence for positive economic consequences?

The evidence is overwhelmingly positive with respect to direct effects. Most of this evidence is based on studies of technical efficiency. In terms of technical efficiency, a mass of empirical data supports the hypothesis that MNCs do significantly outperform domestic rivals in host countries. 2/ One major qualifying comment that must be added, however, is that most of the empirical studies on this issue have focused on labor productivity, which can be increased (without an overall increase in multi-

1/ Interestingly, the evidence for high profit performance for MNCs operating in developing countries is more mixed than for ones operating in developed countries (where in fact the unadjusted profit performance of MNCs is consistently better than that of non-multinational rivals.) However, it is likely that transfer pricing affects reported profits in developing countries more profoundly than in developed countries, so this evidence must be interpreted with caution.

2/ Individual studies are reviewed in Dunning 1993, op. cit.
factor productivity) by substituting capital for labor. Because, as just noted, MNCs typically utilize more capital intensive production methods than do their non-multinational rivals, some of the measured differences in labor productivity might be ascribable to differing factor intensities. However, a limited number of empirical investigations suggest that the multifactor productivity as well as the labor productivity of MNCs tends to be higher than of non-multinational rivals.

Likewise, numerous empirical studies confirm the presence of spillover effects from MNCs in host countries that create benefits to the local economy. As might be expected, the evidence is very strong that linkages between locally owned firms that act as suppliers or distributors for local affiliates of MNCs and these affiliates tend to increase the efficiency of the former. However, some studies have suggested that, in the manufacturing sector, that foreign owned firms do not necessarily provide more technical assistance to their suppliers than do efficient locally owned firms (see, e.g., Goncalves 1986).

Similarly, there seem to be positive spillovers on competitor firms generated by MNC participation in sectors. John Dunning defines two categories of studies of the effects of MNCs upon locally owned competitor firms, those that are based on field studies and those that are based on econometric studies. 1/ Both categories tend to support the contention that inward FDI tends to act as a stimulus to enhance the technical efficiency of local firms that must compete against MNCs. Two qualifying statements must be made, however. First, such studies (of both categories) have tended to examine the medium-term impact of entry by MNCs upon labor productivity of local rivals and have not considered the long-term impact on, say, local R&D capability. MNCs have historically concentrated R&D activity in their home countries and thus, if MNC entry causes local firms to reduce R&D (and if this R&D produces benefits captured in the local economy), some local benefit might be lost and this loss will likely be long-term in nature. 2/ Second, most of the studies have been cross sectional in nature; what they show is that domestic firms that must compete in sectors in which MNCs participate tend to have higher technical efficiencies than domestic firms that do not face such competition. These studies thus do not show whether the technical efficiencies of domestic competitors to MNCs improved following the entry of the MNCs. A limited

2/ However, Coe, Helpman, and Hoffmaister 1994 show via econometric techniques that developing countries capture considerable benefits from R&D performed in the seven largest industrial nations through trade; because trade and FDI links between countries are correlated (see next subsection), some of the benefits ascribed by Coe, Helpman, and Hoffmaister to trade linkages might in fact be attributable to FDI linkages, consistent with the evidence reviewed here. The issue then becomes, do countries lose more benefit if local R&D is displaced by FDI than gain from the FDI linkage.
number of time series studies of this issue have been conducted, but with mixed results. 1/

These empirical observations are roughly consistent with a model introduced by Grossman and Helpman dealing with endogenous technological innovation and trade. 2/ The formal model is a standard two country one, one of which is labor rich in its factor endowment and the other is human capital rich. The principal conclusion of this model is that when technological innovation is endogenous (i.e., is the result of private entrepreneurs who engage in research and development as a profit maximizing activity), and where knowledge diffuses internationally, a variant of the Heckscher-Ohlin result holds, notably that R&D takes place in the country where factor configurations make this a relatively low cost activity (this is the human-capital-rich country). Under certain world factor configurations, however, the cost of manufacture of goods embodying the technology might be lower in the other country, giving firms an incentive to become multinational by manufacturing in locations other than where the R&D is performed. The labor rich country in effect trades commodities for technology.

Overall, the evidence seems to support those who maintain that foreign direct investment tends to have net positive effects on host nation economies. It would seem that, to the extent that there are negative effects associated with monopoly power of MNCs, these are rather minimal and do not manifest themselves in the form of significant monopoly rents. Also, it is probably true that if FDI continues to proliferate, entry by new MNCs from a multitude of home nations will reduce the monopoly power of incumbent MNCs. The evidence that FDI does convey positive effects through technology transfer and transfer of other intangible assets, in contrast to the evidence on negative effects, is very convincing.

This last point is very important to developing nations. As is developed in the next section, inward FDI likely reduces in net the amount of international savings available to these nations. This, taken by itself, would reduce capital formation in these nations and reduce long term growth prospects. However, this effect is likely to be more than offset by growth in productivity due to technology transfer, such that the net effect on economic growth is positive. Furthermore, increases in growth seem to be correlated with increases in the domestic savings rates of dynamic developing countries, such that any reduction in international savings might be more than offset by increases in domestic savings. 3/ The net effect would be a "virtuous circle" of increased domestic savings leading to increased domestic capital formation and hence additional growth. In all

1/ See, for example, Globerman 1985 and Dunning 1985.
3/ On this, see International Monetary Fund 1995, chapter V. As is developed earlier in this paper, multinational firms can intermediate domestic savings into domestic investment.
likelihood, the contribution of FDI to growth in developing countries is thus strongly positive. However, strong empirical evidence of this has yet to be demonstrated, largely because so many factors are at work in the dynamic developing nations that the effects of FDI are difficult to single out.

VII. The Economic Consequences of FDI for Home Countries

Concern over the effects of FDI on home countries has long been focussed on employment, i.e., whether or not outward FDI leads to some form of job loss in the home country. 1/ To the professional economist, such concern is largely misplaced, because overall levels of employment are determined by macroeconomic factors on which FDI has little bearing. The concern is more legitimate, however, if one talks about the quality of employment. Relevant questions then are:

(i) Does FDI lead to sectoral reallocation of employment, such that workers are released from labor intensive sectors in greater numbers than they can be reabsorbed at prevailing wages in other sectors, such that the labor share of national income must fall in order for labor markets to clear? 2/ Alternatively, does outward FDI reduce the demand for high skilled workers in the affected industries, such that these workers must seek jobs in other industries where they are not fully compensated for the skills they possess? 3/ That is, does outward FDI cause "bad" (low paying) jobs to be substituted for "good" (high paying) ones?

(ii) Does outward FDI reduce capital formation at home, such that productivity (and hence per capita income) grows at a lower rate than it would have, had the FDI not taken place?

(iii) Does outward FDI have any effect on the rate of technological innovation in the home country?

Closely related to issue (i) is whether or not FDI and international trade are complements or substitutes, that is, whether increases in outward FDI is related to increases or decreases in exports or to increases in imports of related goods (it is implausible that increases in FDI would be related to decreases in imports). If, say, increases in FDI were

1/ The classic statement of these concerns is Goldfinger 1971. The concerns have more recently been reflected in the 1994 debate over NAFTA in the United States, wherein H. Ross Perot echoed the views of Goldfinger, as well as in an on-going debate in Europe over the "delocalization" effects of FDI.

2/ I.e., that the Stolper-Samuelson effect holds.

3/ An underlying assumption for this to hold is that the skills are not fully transferrable or, alternatively, that they are at least in part sector-specific.
characteristically to lead to decreases in exports (i.e., FDI and exports were to be substitutes) or increases in imports of goods or services (i.e., FDI and imports were to be complements) in the same sector, then the case could be made that outward FDI had the similar effects on the home country economy as import liberalization in the relevant sector (and similar effects on labor markets, i.e., the labor share of national income could be reduced and/or the sectoral composition of demand for labor altered to the detriment of labor income). On the other hand, if increases in outward FDI were to lead to increases in exports (i.e., FDI and exports were to be complements), it would be difficult to construct a case that FDI had harmful effects on labor, assuming that jobs in the affected sector were considered to be "good" jobs to begin!

The issue of whether FDI and exports are substitutes or complements has been rather extensively investigated empirically, and the bulk of the evidence points towards a complementary relationship rather than a substitutive one. 1/ Less research has been performed on the relationship between FDI and imports but the available evidence suggests that this relationship too is complementary. 2/ Thus, outward FDI seems to be positively associated with trade expansion. Both exports and imports seem to expand as FDI grows. It should be noted that the trade expansion is likely to be intra-industry, i.e., that exports and imports grow within sectors and not necessarily across sectors, suggesting that much of the trade is of differentiated products.

What are the implications for labor? Whether the effect of FDI is to reduce labor's share of national income cannot be determined from the data, but such an effect seems highly unlikely (i.e., there is no evidence that FDI causes imports to expand in labor intensive sectors). The effect on the sectoral composition of labor is, however, likely to be positive, because of the complementarity between FDI and exports and evidence supporting the contention that export generating sectors also generate "good" jobs (i.e., ones that pay higher than average wages) in the advanced nations.

The effects of FDI on home nation capital formation depend largely upon the international capital flows created by FDI. As noted earlier, these flows effectively add to or subtract from the pool of savings available to finance capital formation. Given that I = S, where I is domestic investment (which includes new capital investment but also net additions to inventories) and S is the total savings pool (including international sources), it follows that ΔI = ΔS and, ignoring inventory changes, it would seem that a net increase in capital outflows from a host nation will

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displace domestic investment on a one-to-one basis. However, FDI generates a variety of international capital flows including various payments to the parent firms of MNCs located in the home nations as well as the FDI flows themselves (and, as Chart 4 indicates quite clearly for the United States, in recent years, new equity outflows are only a part of U.S. FDI outflows). In addition, FDI can affect the payments of taxes by MNCs to their home governments (from a national income accounting perspective, taxes are part of national savings) and, perhaps, the profitability of home operations of MNCs (affecting retained earnings of these, another component of national savings).

The upshot of all of this is that it is truly difficult to assess what is the effect of FDI on home nation capital formation. There is, in fact, a case to be made for asserting that in the long run, outward direct investment increases the capital stock of a country, because direct investors will require that their investments have net positive present value and hence that future capital inflows must in magnitude exceed current outflows. But this assertion begs the question of what exactly is the "counterfactual". If the alternative to FDI is additional current consumption, obviously a different consequence will follow than if the alternative is additional current investment.

A corollary statement would be that inward direct investment in the long run reduces the international savings of a host nation. While this is almost surely true, it is not at all clear that the effect is either reduced savings available to the host nation or reduced capital formation. Indeed, at the conclusion of the previous section, the case was made that the overall effect would be increased growth and increased capital formation resulting initially from increased efficiency of use of capital, and sustained by a "virtuous circle".

If the effects of FDI on domestic capital formation are, at root, indeterminant, the effects of FDI on domestic R&D activity are more clearly likely to be favorable. This result follows from the following observations.

First, there is a divergence between the total social returns generated by new technology creation and the returns appropriated by the innovator (because of spillover effects). This is a classical result, and one consequence is that private agents, left to their own devices, will tend to underfund R&D relative to what would be the socially optimal level of such funding.

Second, FDI increases the total size of the market available to the innovating firms and hence the appropriable returns available to them. The consequence is that they should be willing to invest more in R&D.

1/ And, for the OECD as a whole, this seems to be the case. See Feldstein 1994.
Furthermore, as an empirical point rather than a theoretical one, they tend to do this in their home countries, albeit that international growth of R&D by MNCs (i.e., R&D not performed in their home countries) has in recent years grown rapidly. The unequivocal result is that FDI should, all else being equal, increase the amount of R&D that is performed. It has also been argued that increased rivalry among multinational firms occasioned by FDI will accelerate the rate at which these firms introduce the fruits of R&D (new or improved products or more efficient ways of producing them) to the market. 1/

That multinational activity should boost innovation in the home country thus seems a plausible hypothesis. Contrary hypotheses can, however, be offered. For example, Porter 1990 suggests that in some sectors, U.S.-based firms have used FDI as a means to switch from relatively higher cost to relatively lower cost areas, and that this has actually suppressed incentives to invest in product and process innovation. The question that is clearly posed then is which of the contrary hypotheses is, in a real world context, the dominant one on the basis of empirical evidence. The answer, unfortunately, is that there is a dearth of hard empirical evidence bearing on this question. General empirical evidence that does exist, however, tends to support the former hypothesis that outward FDI stimulates technological innovation in the home country (see, e.g., Mansfield, Romeo, and Wagner 1979). Evidence for the latter hypothesis tends to be in the form of case studies of particular industries, and one might conclude that while the hypothesis might ring true for certain specific cases, as a general proposition the hypothesis is not on the mark.

The new policy environment

Although MNCs carry out both a large portion of the world's trade and most of its direct investment, the international legal framework for trade is very detailed whereas that for direct investment-related activity (other than trade) is quite limited. This asymmetry has long been observed by certain scholars, who have suggested that there might be benefits to extending the multilateral trade rules to cover direct investment and allied activities. 2/ Some progress was made on that front in the Uruguay Round of multilateral trade negotiations. Three of the Uruguay Round agreements have significant bearing on FDI: the Agreement on Trade Related Investment Measures (TRIMs), which proscribes governmental mandating of certain performance requirements (specifically, local content and trade balancing requirements) that were determined to be inconsistent with GATT obligations; the General Agreement on Trade in Services (GATS), which inter alia binds governments to certain right of establishment and national treatment.

2/ See, e.g., (REFERENCES TO BE ADDED)
standards for foreign controlled enterprises in specified industries; and the Agreement on Trade Related Intellectual Property, which obligates World Trade Organization (WTO) members to certain standards on intellectual property.

Despite this progress, many trade policy officials believe that more language should be incorporated into the world’s multilateral trading rules pertaining to FDI, perhaps in some future multilateral agreement on investment. 1/ As of the time of this writing, there were two very general issues in this regard that were outstanding, notably (i) in what venue would such an agreement be negotiated and (ii) what would be the substantive content of the agreement.

On the issue of venue, the choice at the moment seems to boil down to the Organisation for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO). The OECD has as members the industrial nations only, and the case for the OECD as venue is that there is more consensus on substantive issues among these nations than among a larger grouping and hence that progress could be faster, and the result more profound, in this venue than in the WTO. The case for the WTO as a venue is that almost all the nations of the earth are members or prospective members and that a future multilateral agreement on investment would be effective only if a larger group of nations than the OECD member countries were to agree to abide by its rules.

On the issue of substance, there does seem to be widespread consensus as to broad substantive issues that a future multilateral agreement on investment should cover. Included in such an agreement would be principles pertaining to transparency (host and home nations’ laws and policies regarding direct investment and related activities should be public knowledge and as unambiguous as possible), right of establishment, national treatment (investments, including direct investments, of foreigners should be subject to treatment under law that is no less favorable than that accorded to equivalent domestically-owned investments), and investor protection (including principles pertaining to expropriation). Substantial disagreement among nations, however, lurks beneath the surface at the level of detail. In particular, because all nations would claim exceptions to the general principles, how to deal with these is problematic. There is also considerable consensus that an agreement should deal with investment measures that have the potential to distort trade flows or might otherwise have effects equivalent to trade barriers. These would include performance requirements not currently covered by the TRIMs agreement and perhaps also investment incentives and other subsidies granted by governments to induce foreign direct investors to locate facilities within their jurisdictions. There is much sympathy towards the idea that a multilateral agreement on

1/ This was the major theme, for example, of the keynote speech of Sir Leon Brittan, Commissioner of the European Union for External Relations, before the European American Chamber of Commerce on January 31, 1995.
investment should establish investor/state dispute settlements procedures, to supplement existing state/state dispute settlement procedures embodied in the WTO.

A potential model for a future investment agreement is Chapter 11 of the Agreement Establishing the North American Free Trade Association (NAFTA Chapter 11), which contains all of the elements listed above. However, some critics have noted that NAFTA Chapter 11 has done little except to codify the existing investment rules of the three NAFTA countries (Canada, Mexico, and the United States). These critics believe that without liberalization of existing investment restrictions, negotiation of a multilateral agreement would be a sterile exercise. Other critics, however, believe that NAFTA already goes to far and that, in particular, the investor/state dispute settlement mechanisms in NAFTA Chapter 11 encroach unduly upon national government sovereignty.

The difficulties notwithstanding, an effort will be made at the meeting of the OECD nations at ministerial level, to be held in May, 1995, to develop a mandate for negotiation of an investment agreement. The WTO will likely consider any new investment initiative before its ministerial level meeting to be held in Singapore in December, 1996. Thus, by the time the WTO meeting is held, there might be some progress within the OECD.

The view of this author on the issue of venue is that, in light of the timing of the two ministerial meetings, substance might actually be allowed to drive venue. If substantive progress is being made at OECD, where "progress" means progress towards liberalization, it would then be advisable to allow the OECD effort to continue without a parallel effort being launched at WTO. Then, at some later time, the fruits of the OECD work could then be the basis for negotiations at WTO. If no such progress is made at OECD, by contrast, it would seem advisable that the whole effort be allowed to migrate to the WTO. As has been noted by a number of trade policy experts, oftentimes trade liberalization is more easily achieved in a "big package" than in a small one. The reason is that political constituencies in favor of liberalization can be counted on more reliably to provide political support for a big package than a small one, whereas often a small package galvanizes the special interest opposition more effectively than the liberalization constituency. 1/ Thus, failure to achieve liberalization at OECD might not necessarily imply automatic failure at WTO.

If neither the OECD nor the WTO prove to be fertile ground for a multilateral agreement on investment, there are other possible venues. Prime among these would be the Bretton Woods Institutions, the World Bank or the IMF. The World Bank already contains much expertise in the field of

1/ For example, in the United States, the political forces in favor of liberalization seemed more prepared to fight for passage of the Uruguay Round legislation than for other trade liberalizing legislation in recent times. See Schott 1994.
direct investment policy, notably within the International Centre for the Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA). ICSID was created to facilitate settlements of disputes between investor firms and host nations. One hundred thirty nations currently are signatories to the ICSID. However, the ICSID has not been frequently used as a facility actually to settle investment disputes. But ICSID could become much more active in the future if it is used, as envisaged, as the principle arbitral body for the settlement of investment disputes under the North American Free Trade Association chapter 11, part B.

MIGA is an institution designed to supplement and perhaps eventually supplant national investment insurance programs. MIGA was designed to encourage FDI specifically in developing economies. Like ICSID, MIGA to date appears to be somewhat under utilized. In 1994, one hundred forty seven countries were signatories to MIGA, but only about 100 contracts were outstanding, with contingent liabilities of about $1 billion. However, the demand for MIGA guarantees has been rising, especially for insurance associated with investment in the formerly socialist nations.

The main advantage of the World Bank thus is that many of the facilities that might be attached to a multilateral investment agreement already exist within the Bank. If the venue chosen for such an agreement were to be the Bank's sister organization, the IMF, these facilities would be located close by. The advantage of the WTO is that trade and investment policy issues are complementary and, thus, it would be desirable for the secretariats associated with a new investment agreement to work closely with the existing WTO staff. However, the overriding objective would be to achieve the best possible agreement, and if choice of venue were to affect outcome, the venue that enabled this objective should be the one chosen.
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