Improving Russia’s Policy on Foreign Direct Investment

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Summary findings

All countries—developing and developed alike—find it difficult to stay competitive without inflows of foreign direct investment (FDI). FDI brings to host countries not only capital, productive facilities, and technology transfers, but also employment, new job skills and management expertise. These ingredients are particularly important in the case of Russia today, where the pressure for firms to compete with each other remains low. With blunted incentives to become efficient, due to inter-regional barriers to trade, weak exercise of creditor rights and administrative barriers to new entrants—including foreign invested firms—Russian enterprises are still in the early stages of restructuring. This paper argues that the policy regime governing FDI in the Russian Federation is still characterized by the old paradigm of FDI, established before the Second World War and seen all over the world during the 1950s and 1960s. In this paradigm there are essentially only two motivations for foreign direct investment: access to inputs for production, and access to markets for outputs. These kinds of FDI are useful, but often based either on exports that exploit cheap labor or natural resources, or else aimed at protected local markets and not necessarily at world standards for price and quality. The fact is that Russia is getting relatively small amounts of these types of FDI, and almost none of the newer, more efficient kind—characterized by state-of-the-art technology and world-class competitive production linked to dynamic global (or regional) markets. The paper notes that Russia should phase out the three core pillars of the current FDI policy regime -- (i) all existing high tariffs and non-tariff protection for the domestic market; (ii) tax preferences for foreign investors (including those offered in Special Economic Zones), which bring few benefits (in terms of increased FDI) but engender costs (in terms of foregone fiscal revenue); and (iii) the substantial number of existing restrictions on FDI (make them applicable only to a limited number of sectors and activities). This set of reforms would allow Russia to switch to a modern approach towards FDI. The paper suggests the following specific policy recommendations: (i) amend the newly enacted FDI law so as to give “national treatment” for both right of establishment and for post-establishment operations; abolish conditions that are inconsistent with the agreement on trade-related investment measures (TRIMs) of the WTO (such as local content restrictions); and make investor-State dispute resolution mechanisms more efficient, including giving foreign investors the opportunity to seek neutral, binding international arbitration; (ii) strengthen enforcement of property rights to improve corporate governance incentives; (iii) simplify foreign investor registration procedures and make them rules-based and transparent; and (iv) extend guarantee schemes covering basic non-commercial risks.
Improving Russia’s Policy on Foreign Direct Investment*

Introduction

As the much-discussed "global market" has become a reality over the last ten years, all countries find it more difficult to stay competitive without FDI. Noteworthy, the most competitive economy in the world, the United States, is not only the largest single source of, but also the largest single destination for FDI. The countries of the European Union are also among the largest sources and destinations of FDI. Among the developing countries, and among the transition countries of both Europe and Asia, the fastest growing ones are the biggest recipients of FDI. The empirical evidence suggests that for emerging economies, a one percentage point increase in FDI (measured as a proportion of GDP) leads, ceteris paribus, to an extra 0.8 percentage point increase in per-capita income.¹ Of course, part of the cause-and-effect is that growth attracts FDI. But there are important causation forces from FDI to competitiveness - FDI brings at least four things of value: financial capital, management skills, technology, and access to export markets -- and therefore sustains growth as well.

Russia can and should take full advantage of benefits associated with inflows of FDI. Given the country’s large endowment of natural resources and educated labor force, as well as its potentially large market, this might seem as a not too difficult task. Yet the record is discouraging. In spite of explicit efforts by government to lure investors, Russia has received far less FDI than it could, both relative to its economy’s size and in comparison with other emerging markets. From 1992-1999, cumulative FDI inflows to Russia total about US$16 billion. This level of FDI is very low in light of Russia’s vast attractive resources—both natural and human—and her great economic potential. It is also very low relative to other transition countries in the region, adjusted for population size: on a per capita basis, cumulative FDI in Russia is US$15, compared to US$84 for Poland, US$118 for the Czech Republic and US$221 for Hungary. This result implies, in part, a flawed policy strategy regarding FDI.

This paper analyzes Russia’s policy regime governing FDI and suggests policies to bring it in line with international practice. We begin with a discussion of how the emergence of globalization has affected the nature of FDI, both from the standpoint of investors and host countries. We then turn to a review of the provisions related to FDI embodied in the WTO, to which Russia is seeking accession. This is followed by an analysis of the current FDI policy framework in Russia. We then present an overview of best international FDI practices. The paper concludes with recommendations for improving Russia’s FDI policy regime—stemming both from the necessity to attract cutting edge FDI and to comply with WTO norms.

Globalization and Implications for Competition for FDI

In many transition economies, there is poor comprehension of important changes in a world-wide pattern of FDI over the last two to three decades. The key word for these changes is globalization of FDI.

* This paper updates and draws on Bergsman, Broadman and Drebentsov (1999).

¹ See JPMorgan (1998).
“Globalization” is a widely used expression, which covers three main mutually reinforcing processes:

- **Country policies**: More and more countries have continued to liberalize their economic policies over the last decade or two, becoming more open both to trade flows (lower tariffs, fewer quantitative restrictions, currency convertibility) and to FDI flows (fewer restrictions on which sectors are open or percentage of foreign ownership allowed, abandonment of case-by-case approval procedures, etc.). The ones that are not open are experiencing difficulties in maintaining growth.

- **Company behavior**: More and more multinational corporations (MNCs) are adopting integrated regional or even global strategies, using both subsidiaries and strategic allies to locate interdependent facilities in various countries so as to maximize their competitive edge worldwide. This is a change from the dominant behavior of 10 or 20 years ago, when MNC subsidiaries in foreign countries were operated more or less independently of each other and were located anywhere there was a market and without regard to whether the locale offered the conditions necessary for world-competitive price and quality production.

- **Technology**: Huge improvements in international transportation and communications, combined with greater use of electronic controls and information storage and transmission, have made the opening of countries, and the change in behavior of companies, viable and important. Computer-aided design and manufacturing ("CAD-CAM") make it possible to design a product, and the software that will control some of the machines that produce it in one location and have the production process changed and running in another location anywhere in the world in a matter of hours or at most a day or two. Other changes in communication technology have also drastically reduced many of the costs of locating interdependent activities in more than one location.

The changes in technology, behavior and policies reinforce and validate each other. Globalization is a positive-feedback process. Because of this, the world is separating into two kinds of countries: those that offer competitive conditions for production, attract FDI, trade, and experience continuing increases in productivity and hence in incomes, and those that do none of these things and stagnate.

In the course of globalization it has become apparent that international trade and FDI complement each other. Of course in some transactions FDI is a substitute for trade; especially in large markets a foreign company may decide to locate production facilities in the market as an alternative to trying to export from its home country. But in today’s globalizing world, trade and FDI go together. In fact, for many MNCs the edge between trade and FDI becomes thinner and thinner. As one business executive noted at a recent meeting of the OECD Trade Committee: “Firms trade to invest and invest to trade.” Of all world trade, intra-firm trade among MNCs accounts for about one-third, and MNC exports to non-affiliates accounts for another one-third. Thus, only the remaining one-third of world exports does not directly involve MNCs.²

Within this context, the location of the most efficient, up-to-date, competitive facilities is decided more by MNCs and less by arms-length, market forces. As a result, even very large countries find it more difficult to “go it alone.” In terms of economic development it has become very costly for any country, developing, developed or transitional, to be outside this web of globalized production.

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² For a discussion of intra-firm trade, see Broadman (1991).
Two other aspects of MNC behavior are also results of the above-mentioned changes in the world economy and forces that validate and increase those changes:

- **Inter-company collaboration:** Spurred by the success of the Japanese *keiretsu*, more and more companies are actively collaborating with suppliers in the design of their products and/or processes, and are taking actions to nurture long-term relations (e.g., less subject to being switched on-off in response to short-term changes in demand or other short-term forces). Just-in-time inventory policy is only a part of this. Some elements of these trends have increased the importance of locating interacting facilities near each other, in opposition to the forces that decrease the costs of distance described above.

- **Intense competition among companies and countries:** The greater openness of national economies and the growing multinational consciousness of businesses have dramatically increased competition in product and factor markets almost everywhere. Comfortable, "quiet life" production at less than world-standard quality and price is a rare luxury for management and labor as well. Prospects for such production have no appeal for MNCs, and today, investors are very reluctant to locate important facilities anywhere that offers them second-class conditions. What MNCs are looking for is a set of policies that simultaneously provide security of market access and nondiscrimination vis-à-vis domestic investors. Partially beneficial policies are not appropriate anymore; for to put at stake state-of-the-art investments, MNCs need to be sure in stability along the whole trade-investment continuum. MNCs do establish facilities in higher-cost or higher risk locations when there are attractive markets; but they are often not integrated into their international strategies, may not have their best technologies, and do not bring the full potential benefits of FDI. Hence keeping a restrictive or even a distorted type of FDI regime prevents an economy from harvesting all benefits associated with the modern-type inflow of capital.

Having a less favorable FDI regime relative to what other countries offer is especially detrimental to the economy because countries compete for FDI among themselves. In the 1950s and 1960s, countries competed for export-oriented FDI but did not have to compete for FDI that was oriented to domestic markets -- just a large market, with protection from imports, was enough. Thus, a country such as Russia would not have offered tax holidays, cheap land, or other incentives.

Today, with globalizing investment becoming more important, even countries with large markets have to compete. Privileges often offered to FDI seem as a natural response to this competition. However, the most effective instruments of such competition do not include tax concessions or other types of foreign investment preferential treatment (see below). Rather a reasonable, transparent and stable tax system is necessary to attract modern FDI; extremely low rates or special treatment is not. Most of the countries that are succeeding in attracting this kind of FDI are in fact not offering such special treatment -- the exceptions are a few Asian countries that have been caught in a bidding war amongst themselves. Russia needs to undertake a comprehensive review of its FDI policy regime and substitute a stability-and-safety package for old-type privileges if it wants to attract today’s foreign investor.

Russia’s harmonization with the realm of globally operating MNCs is discretionary. But Russia is also acceding to various international economic institutions, of which the World Trade Organization (WTO) is of key importance for shaping national policies towards FDI. Russia, as a nation seeking accession to the WTO, will have no other option but to harmonize its regime with WTO requirements. It is important for the government to have a clear understanding of both those regimes and the inconsistencies with them that current policy presents.
International Agreements and Russia’s FDI Policy Regime

The Agreement on “Trade-Related Investment Measures” (TRIMs), entered into by WTO members during the Uruguay Round, has a direct bearing for shaping the FDI regime of a country seeking WTO membership. Acknowledging that certain measures towards investment have apparent restrictive or distortive implications for international trade, the TRIMs Agreement stipulates that no signatories shall apply any TRIM inconsistent with the Article III and Article XI of the GATT 1994.

Fleshing this out, the Appendix to the TRIMs Agreement lists some types of prohibited TRIMs. Among such measures, be it a mandatory requirement or a prerequisite for obtaining some privilege, are:

(i) those that require particular levels of local sourcing by an enterprise - “local content requirements”;

(ii) those that restrict the volume of imports which an enterprise can buy or use to the volume or value of products this enterprise exports - “trade balancing requirements”;

(iii) those that restrict the volume of imports to the amount of foreign exchange inflows attributable to an enterprise - “sufficient foreign exchange earning capacity requirements”; and finally

(iv) those that restrict exports by an enterprise either in terms of the particular type of products (or their volume or value), or, generally, in terms of a proportion of local production - “supply to local market requirements.”

It seems at the moment that the second and the third clusters of potential non-compliance are not relevant to Russia. Indeed, there are no such restrictions in existence so far. Yet as we show below, Russia is a clear case for both the first and the fourth groups of inconsistent TRIMs. It is particularly so if one bears in mind that, as the above text indicates, prohibited TRIMs include not only explicit bans or restrictions, but also any condition of a nature described in one of four clusters above that is necessary to comply with to obtain an advantage.3

Another item that is critical with respect to the TRIMs Agreement pertinent to Russia is as follows: the Agreement requires the mandatory notification of all non-conforming TRIMs covered by the above list (whether they are implemented at the federal or sub-national level), and calls for elimination of such TRIMs over a transition period. The transition period varies according to a country’s status. Since Russia has, to date, notified the WTO Secretariat that it is going to accede to this organization as a developed country, the transition period will be just two years, in contrast to the five years granted to developing countries. Similarly, neither potential extension of the transition period nor an allowed deviation form the provisions of the TRIMs Agreement, that are available to developing countries, could be utilized by Russia.4

3 The term “advantage” is not defined in the TRIMs Agreement. However, it is understood to cover all forms of preferential treatment, including tax-based or interest rate-based ones.

4 Unavailability of the latter temporary deviation acceptable to WTO, if carried out by a developing country for balance-of-payments purposes, seems to be a particular loss for Russia given persistent attempts by the authorities to introduce language on trade restrictions for balance-of-payments purposes into the national
Apart from the WTO, there was, until recently, another proposed international agreement on FDI: the Multilateral Agreement on Investment (MAI) -- the OECD countries’ initiative. Although negotiations for the MAI have been suspended, when and if it comes into existence, the MAI would replace the current world-wide network of bilateral investment treaties (BITs), regional agreements and OECD-type vehicles (Codes of Liberalization or Declaration and Decisions on International Investment and Multinational Enterprises).

Russia’s FDI Policy Regime: Achievements and Challenges

It should be acknowledged that Russia has been constantly and explicitly trying to attract FDI, and hence make the FDI regime more attractive. However, a relatively small amount of accumulated FDI suggests that the government has not been very successful. Of course the lack of political and economic stability has been an important stumbling block and even a first class policy towards FDI would not suffice to overweigh that. While acknowledging the importance of macro stability, nonetheless, Russia’s FDI regime has significant flaws.

The most serious challenge Russia faces at the moment is to switch from an obsolete approach towards luring foreign direct investment to modern one. The former, in the case of Russia, involves relatively high tariff protection of the domestic market, and on top of that, specific privileges offered to FDI. The latter approach would require getting rid of both these sticks and carrots, and providing foreign investors with a generic climate conducive for attracting cutting-edge capital. We will come back to this issue. Let us start with a review of specific problems of the Russian FDI policy regime.

TRIMs Inconsistent with WTO Rules. The first and the smallest cluster of such problems comprises procedures inconsistent with the TRIMs Agreement. The government has notified the WTO Working Party of just a single prohibited TRIM so far. Moreover, the government has stated that even that TRIM is not implemented. Indeed in December 1997 the government submitted to the WTO Secretariat an Addendum “Regime in the Area of Trade Related Investment Measures”, which claims that while “[the] Russian national legislation currently in effect contains no general trade-related investment measures inconsistent with the requirement of the TRIMs Agreement”, the Chapter II of the Federal Law “On Production Sharing Agreements” (PSA) contains the following language:

Grant Russian legal entities, all other factors being the same, a preferential right to participate in the performance of operations under the [Production Sharing] Agreement as contractors, suppliers, carries or otherwise... The Parties shall stipulate in the Agreement that at least a certain portion of the basic equipment for mineral production and processing... to be purchased by the investor with subsequent cost recovery out of compensatory share of products shall be manufactured within the Russian Federation.

The government has stated that “for full implementation of this law, the adoption of additional normative legal acts is required”, and that no actual contracts signed so far under an umbrella of the PSA legislation contain conditions specified in the law.

legislation and other normative acts. Accession to WTO would make these attempts useless for Russia will not be permitted to use this excuse.

5 Today, there are over sixteen hundred active BITs entered into by various countries.
At least three additional TRIMs Agreement inconsistent measures have been contemplated by the Russian authorities in 1998. Even in 1997, when notification was submitted, the PSA law did affect actual agreements -- if not yet contracts -- of partners involved in deals covered by the PSA legislation. Two examples are the Prirazlomnoye and Sakhalin-1 oil field projects. In the former case, the Russian government issued a decree explicitly naming a Russian producer (Sevmash company) the main equipment supplier for the project. In the latter, the agreement states that at least seventy percent of equipment for the project shall be procured from Russian producers. These requirements constitute a clear case of the first-type TRIMs prohibited in the Illustrative List annexed to the TRIMs Agreement.


While selling privatization objects at a commercial tender, there might be established an investment condition in a form of a winner's obligation to carry out prescribed measures for tariff and non-tariff protectionism of the Russian producers, including procurement of the Russian raw commodities, materials and semi-processed goods...

Moreover, on April 23, 1998 the Government issued Resolution No. 413 “On Additional Measures to Attract Investment for the Development of Domestic Automobile Industry”, which inter alia establishes an explicit link between granting an investor the right to import under the “Free Warehouse Customs Regime” – an exemption from paying import duty on any imports used in a project by an investor -- and “share of costs incurred on the territory of the Russian Federation.” In view of the earlier comment that TRIMs Agreement inconsistent measures include not only mandatory ones, but also those conditions that are prerequisites for obtaining an “advantage”, such a “local content” TRIM constitutes a clear breach. Similar infringement of the TRIMs Agreement will be established by another government Resolution. That Resolution creates a direct link of government’s approval of the national air carrier Aeroflot’s purchases of foreign made aircraft to its purchases of domestically produced airplanes (in proportion of one imported plane per four Russian-made ones).

Another apparent example of TRIMs Agreement inconsistency has been recently created by the national quasi-state bank, Sberbank, which announced a lending policy in mid-1998. It started to grant preferential interest rates on commercial loans to companies purchasing Russian-made products (24 percent vis-à-vis 27 percent for purchases of imported goods), which again falls under the first-type of prohibited TRIMs.

Finally, resolutions falling in the fourth group of prohibited TRIMs are issued from time to time. The most recent examples were resolutions establishing an export quota or a temporary export tax on exports of fuel oil. It was also reported the Prime Minister ordered oil companies that did not honor agreed shipments to domestic agricultural consumers would be deprived of access to export pipelines. Such measures are typically considered to be TRIMs Agreement inconsistent.

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6 Sberbank is formally a commercial bank, yet it is predominantly owned by the Central Bank of Russia.

7 In fact, even if there were no TRIMs Agreement, this measure would still be considered WTO inconsistent, for this is exactly a type of measures prohibited not only by TRIMs Agreement, but also by an earlier Agreement on Subsidies and Countervailing Measures.
General Problems of the FDI Regime. Although the above problems are significant, they should not pose a difficult dilemma for the Russian authorities. Indeed, if Russia is keen on WTO accession, the government has eventually no choice but to face the necessity to eliminate inconsistent TRIMs. It is not as simple with other peculiarities of the Russian FDI regime, where government agencies exercise much greater discretion, and hence, might consider changing the current approach only if convinced that revisions would serve Russia’s interests. This is a much bigger cluster of problems than the previously discussed ones. For simplicity of analysis it is convenient to divide it into two groups: (i) remaining excessive restrictions on FDI, and (ii) unnecessary privileges granted to FDI.

Restrictions on FDI. Many countries have restrictions for FDI in sectors considered strategic, either in terms of national defense or economic stability (financial sector), or vital for preserving national identity (most commonly, culture and mass media). Formally, Russia does not deviate significantly from this pattern. The Federal law establishing the set of activities with banned or restricted FDI does not look completely unreasonable. In fact, in the first list attached to this law -- which establishes activities prohibited for foreign investors -- there are only a relatively few areas. The second list attached to this law -- comprising activities with restrictions for FDI -- is more problematic. On top of military-related or dual technologies, it includes (i) many infrastructure sectors – (a) federal electric energy distribution systems\(^8\), (b) communications, (c) marine transportation, (d) aviation, (e) railroads, (f) civil airports construction, (g) highway maintenance and surveillance, etc.—as well as (ii) production of maps and globes, (iii) pharmaceuticals, (iv) ethyl alcohol, (v) alcoholic beverages, (vi) specialized investment funds, (vii) land research and development, (viii) auditing, among many other sectors. It is difficult to rationalize the need to restrict foreign investors’ participation in many of these activities, particularly given that many of these sectors desperately need an injection of modern technology or managerial skills that FDI brings in.

With regard to restrictions in Russia’s financial sector, many countries have restrictions of this kind. Still, the current ceiling for foreign capital in (ix) banking -- 12 percent – might be increased without a real threat to national banking independence while contributing to enhancing efficiency of banking services. The latter is particularly important at the current stage of market transition in Russia, where resumption of economic growth is hampered in part by the lack of efficient financial intermediation for domestic savings and by the shortage of affordable commercial credit to the real sector. The same is true with respect to (x) insurance, where direct activities of foreign owned companies are entirely prohibited, and foreign ownership is limited to 49 percent of Russian insurance companies’ charter capital.

The next layer of restrictions is associated with the State Privatization Program (SPP), which is approved on an annual basis. The current draft SPP is more liberal towards FDI than its predecessors. It reduces several types of previous restrictions and limitations -- like discretion of local authorities to allow foreign participation in privatization of medium and small companies, the right of the Federal Security Service to recommend annulling results of privatization auctions if it has objections to a foreign winner, and so on. This liberalization is rooted in the federal law establishing lists of sectors where FDI is either banned or restricted.

Preferential Treatment of FDI. Simultaneously with considering easing most of the above restrictions, the government should eliminate specific privileges offered to foreign investors. One of them is free customs warehouse imports. In addition to that, the government grants import duty

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\(^8\) An example of exercising this right was the passage by the Duma of a law establishing a 25 percent ceiling on foreign ownership of RAO UES shares.
exemptions. The most recent example of the latter is a decree that slashes by a half all import duties due on shipments of those foreign companies that will bring over $100 million in investment into the country.

There is much cross-country evidence that tax concessions are not only inefficient mechanisms for facilitating FDI, but they are quite costly to the fiscal balance—an obvious point that cannot be overemphasized in the Russian context. In fact, a lot of countries that in the past have experimented with this approach to attract FDI, including Indonesia, Morocco, Romania, Latvia and China, have since started to phase out tax preferences for FDI. The Russian government, whose finances—absent high oil prices—would be under enormous pressure, has even more incentives to follow that path. The same is relevant to Russia’s Special Economic Zones. Most of them have never moved further than just being established by a decree. Yet three that have become operational -- Ingushetia, Nakhodka and Amber (“Jantar”, Kaliningrad) – arguably have engendered more abuses and distortions than advantages.

Indeed, as early as 1992 the World Bank’s Foreign Investment Advisory Service (FIAS) warned the Russian authorities that “if the special [tax] treatment goes only to foreigners, then there will be... the formation of hundreds and then thousands of false joint ventures or foreign-owned companies, in which local entrepreneurs find friendly foreigners to lend their names to enterprises and thus reduce tax liability.” Serious foreign direct investment is not primarily attracted by tax concessions, nor by the same token inhibited by reasonable tax rates. What matters more is consistency, transparency and predictability of the tax system. Indeed, the authorities’ own analysis of foreign investors’ complaints about Russian taxation highlights the problems of instability, inconsistency and non-transparency.

Of much higher priority to foreign investors relative to tax breaks is an ability to present an appeal on rulings by the tax service without suffering up-front fines and levies, and, in case amicable resolution is not possible, the ability to apply to an efficient dispute settlement mechanism. The lack of independent and efficient arbitration is one of the main stumbling blocks for FDI in Russia. This is particularly so given the sheer number of overlapping regulations and numerous inconsistencies between various laws and other normative acts, such as Presidential Decrees, Internal Directives of the government and ministries, federal and local procedures, etc. This muddle does not contribute to building foreign investor’s confidence. An example of what this incoherence causes for the country occurred in May 1998 when parliamentary passage of restrictions on foreign ownership of RAO UES contributed significantly to turmoil on the Russian financial market.

The latter issue raises another important barrier faced by foreign investors in Russia. This is “red tape” involved in foreign investor activities. It starts with registration procedures that are openly considered by investors as one of most cumbersome processes in the world. Instead of being a one stop-low burden exercise, an investor obtaining government approval faces the necessity of getting clearance by at least 5 to 6 ministries and agencies, which takes from 3 to 6 months”. Of course domestic investors have to deal with a lot of red tape, too. But putting additional burdens on foreign investors, who by definition face distinct disadvantages in carrying out business transactions in a different culture than their home turf, seems counter-productive. It is

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9 For analysis of the FDI policy regime in China see Broadman and Sun (1997).
11 See for example Foreign Investment Advisory Council (1994).
12 For details see Foreign Investment in Russia: Trends and Prospects (1995).
certainly contrary to the notion of “national treatment.” Clearly, comprehensive simplification of business registration/licensing procedures would generally be conducive to development of Russia’s market economy.

International Experience in Reforming FDI Policy Regimes

The old paradigm of FDI, established before the Second World War and seen all over the world during the 1950s and 1960s, still characterizes FDI in the Russian Federation today. In this paradigm, there are essentially only two motivations for foreign direct investment: access to some inputs for production, and access to markets for outputs. The inputs that attracted investment were varied, including natural resource deposits, low-cost labor, and lesser ones such as good climates for tourism. The attraction of inputs continues to be important to this day although the importance of low-cost labor is decreasing. Countries that were strong in one or both of these attractions received a lot of FDI, even if their political, legal, or economic conditions were second-rate. Countries without large and growing markets, and without natural resources or very cheap labor, were not important destinations for FDI. Brazil, for example, received relatively large amounts of FDI during the 1950s and 1960s, almost all aimed at producing for the large and protected market, and most of it manifested in high-cost, low-productivity facilities that would never export and were not intended to strengthen their parent companies in any significant way.

These two kinds of FDI also differed sharply in their relationship with trade. Input-seeking FDI greatly increased trade and in fact was dependent upon it. Market-seeking FDI was a substitute for trade and in many cases depended on trade restrictions. Most FDI in those days was “greenfield” investment – that is, it was embodied in the construction of new factories.

Global flows of FDI have tripled in the last ten years, while those flows to developing and transition countries have increased by a factor of 10. A significant part of this explosive growth has not been in greenfield activities but rather in mergers and acquisitions (M&A). Inward M&A in the developed countries – mostly the European Union and the US – has been running at 40 to 60 percent of inward FDI during the 1990s, and in the transition countries of Central and Eastern Europe, the ratio has been about 50 percent. The dominant motivating force behind this M&A activity has been to rationalize and strengthen the competitive edge of the investing company by giving it facilities for global or regional strategies of creating interdependent production, administration, research and development, accounting, design, and other parts of its business. Of course, some additions to physical capacity usually follow these mergers and acquisitions. But the driving force is the search for corporate-wide (i.e. worldwide) efficiency and competitive advantage. Sheer large markets do not suffice to attract this kind of FDI. Hence, unfortunately, not much of it is seen in countries such as China or Russia.

In this newer paradigm, almost all FDI is complementary to trade. Brazil, which received US$16 billion in FDI in 1997, has experienced increasing FDI that integrates it into multinationals’ international production strategies. Already several years ago, Ford engines were made in Brazil, exported to Canada where they were assembled into finished automobiles, and then sold in the United States. In March of 1998 Ford announced plans to build two of its new “world car” models in Brazil, which will require new investment of around US$1 billion before the end-2000. This is in addition to the $2.5 billion they had already planned to invest in Brazil. Ford plans to build on its domestic sales base to use the country as its base for exporting not only to the Mercosur region (neighbors in South America) but also to other continents. This is the kind of foreign direct investment that most strengthens economies into which it goes, and that provides the best foundation for continuing increases in productivity and income. The $10
billion of FDI that Brazil received in one month in 1998 is about equivalent to the FDI Russia has attracted in the seven years 1991-1997.

Other reforming countries are also attracting this internationally linked FDI: Ninety percent of all television receivers sold in the United States are made in Mexico, almost all of them by subsidiaries of multinationals from Japan, Korea and other Asian economies. Hungary is one of the world leaders in attracting FDI without natural resources or particularly cheap labor, and this FDI has sparked enormous growth in exports of high- and medium-tech manufactured goods, especially machinery and equipment, and machine parts. Costa Rica has similarly attracted a lot of high-value FDI, including recently an Intel chip assembly and testing plant; Costa Rica has higher wages than Mexico or its neighbors in Central America, but attracted Intel with its rule of law and strongly facilitating investment climate. The Annex presents a detailed analysis of the sequence of economic reforms undertaken by Mexico, and the results in terms of both quantity and kinds of FDI that were attracted.

Conclusion and Policy Recommendations

There is a short set of characteristics that determine which countries are part of the global web of FDI and multinational production. These elements of attractiveness have changed a bit over the last couple of decades as globalization has taken hold, but basically derive from first principles of economics. An up-to-date list would now include the following items:

- political and economic stability, to provide reasonable predictability for making business decisions;
- government behavior that facilitates doing business, rather than harassing it;
- an FDI legal framework in line with best international best practice, with security of property and of persons and enforceability of contracts;
- an enabling environment for domestic market growth, including adequately developed physical infrastructure networks and well-trained workers; and
- the availability of all these conditions to all companies automatically and by law, i.e. rules-based, without a need for special treatment, particular deals, or discretionary decisions by either elected officials or civil servants.

This last point—a rules based FDI policy regime—is key. It is one of the reasons why Russia’s accession to the WTO is so important. Indeed, accession to the WTO will certainly be a positive step for Russia. It would be both an actual and symbolic step towards Russia’s harmonization with international economic policy practices and bring it in line with the new paradigm of FDI. As noted above, it would

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13 For an analysis of why Intel chose Costa Rica, see Debora Spar (1998). The conclusion says, in part: “What drew Intel to Costa Rica, and what was vital in convincing the company to invest, were the basic characteristics of Costa Rica’s political and economic system. The country is a democracy, it is stable, it is liberal, and generally committed to economic openness and progress. Its government’s attitude toward private enterprise is basically facilitating, rather than harassing. It also has a fully transparent legal system... Note the other locations of Intel’s largest overseas facilities: Ireland, Israel, Malaysia. While clearly different in many respects from Costa Rica, they share a common pool of political and economic assets. They are stable, democratic, and relatively free of the corruption and legal fluctuations that plague many of their neighbors...”
require Russia to bind itself to avoid many practices that impede investment as well as trade, and to take other positive steps that will attract high-quality FDI. The simultaneous or closely coordinated formulation of trade policy and FDI policy is an important step forward for Russia.

In this respect it is worth noting that in its 1996 World Investment Report, the United Nations Program on Transnational Corporations analyzed the new paradigm and concluded:

*The decision to locate any part of [a company’s operations] wherever it is best ... means that FDI and trade flows are determined simultaneously. They are both the immediate consequences of the same locational decision... [This] presents new challenges for national policy makers. The need for coordinated policy approaches acquires greater importance... National trade and FDI policies have typically evolved separately, frequently influenced by different goals, and administered by distinct, often loosely connected agencies. This ... separation is not suited to a world in which trade and FDI are closely interlinked. (pp. xxiv-xxvi)*

Beyond the basic conditions enumerated above, a good investment climate for a country such as the Russian Federation is made up of many specific elements. There will be a payoff from improving conditions for every kind of business, and for business generally.

One of the most damaging elements is the tax system, in which instability, a heavy burden, and arbitrary enforcement are a major deterrent to foreign investors. The recently passed portion of the Tax Code will help in this regard, but more needs to be done. Repeated efforts to amend or change the June 1991 law on FDI are another source of serious uncertainty for investors. That law, while it has its weaknesses, is not a major impediment to FDI; the recent amendments to that law, however, are a step backward.

There need to be stepped up efforts in dealing with crime, corruption, lack of security of property and persons, and enforcement of contracts. This multifaceted problem, for foreign investors and Russian citizens and companies alike, is getting worse rather than better. It is a major deterrent to FDI, and especially to cutting-edge, world-class FDI facilities. Even when appropriate legislation exists, the courts are unable to enforce procedures and outcomes. It is important to strengthen the legal/judicial framework to allow for credible property rights and adequate contract enforcement.

Many countries have paid increasing attention to the problem of corruption, and the debate on possible policy options is on-going. There is no single solution. Recent insights suggest that corruption arises when institutions have monopoly positions, there is the ability to exercise discretion and incentives for accountability are weak. Additional laws themselves are unlikely to bring about significant reduction in corruption. Effective reform must be directed to changing the system: (i) introduction of independent oversight of agencies; (ii) clarifying and making transparent how much official discretion can be exercised; and (iii) utilizing penalties and rewards for conduct. Russian authorities should give consideration to establishing independent anti-corruption oversight (“watchdog”) bodies at the federal and regional levels; models can be found in other countries, such as Hong Kong, Singapore, Botswana and Chile. These two sets of problems are so severe that most actions on other elements of the business climate that the Federation Government (including the Duma) might take will probably not succeed in attracting much more FDI, with the exception of production sharing agreement legislation for the exploitation of minerals and hydrocarbons.

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14 See, for example, R. Klitgaard (1998) and C. Gray and D. Kaufmann (1998).
Rules-based, streamlined business licensing at the Federal and local levels needs to be put in place. Measures are needed to address the problem that the setting of license fees is subject to the discretion of local authorities, which results in price discrimination and arbitrary rule. Reforms here are a top priority. They should be based on other countries’ experiences and on enacting legislation that sets precise, streamlined limits at all levels of government on the time and money required to get a business license in most sectors, and codifies sizeable criminal sanctions for officials who violate this rules-based system. For certain sectors, such as human health, the environment and national security, more stringent procedures could be applied.

The industrialized countries have large markets, and they also provide the conditions described above. That is why they receive over two-thirds of all FDI flows -- in spite of generally high labor costs, high tax rates, and other factors often said to repel FDI. Brazil, Mexico, Hungary, the Czech Republic, and Poland are examples of other countries, large and small, that are providing the right conditions for production and trade and thereby attracting efficiency-seeking investments. A few other small countries, such as Botswana, Costa Rica and Estonia, have created a competitive advantage for themselves where none existed in nature, by developing business-friendly laws, regulations, and administrative practices. Within the Russian Federation, regions such as Novgorod, Nizhny Novgorod, Vladimir, Samara, Ekaterinburg, Kazan, and Novosibirsk have done the same thing – attracting investors by creating better business conditions.

The inherent attractiveness of Russia as a place for foreign direct investment means that Russia does not have to be perfect on every item discussed here. Moreover, the necessary improvements would be just as beneficial for Russian companies as for foreign-owned ones. The single most important task is to create a decent environment to do business honestly and efficiently.

Overall, for Russia to switch to a more modern policy approach to FDI, three core pillars of the current FDI policy regime will have to be reformed -- (i) eliminating the relatively extensive non-tariff protection given to the domestic market, (ii) phasing out existing tax preferences for foreign investors, and (iii) reducing significantly restrictions on FDI to a limited number of activities.

The following are specific high priority reforms that are needed to bring Russia’s FDI policy regime up to best international practice:

1. The federal law “On Foreign Investment” should be amended to ensure that it will (i) grant non-discriminatory, “national treatment” to foreign investors for both right of establishment and post-establishment operations; (ii) prohibit the imposition of new and the phase out of existing trade-related investment measures (TRIMs), e.g., local content measures, export performance requirements; restrictions on use of foreign exchange; trade balance measures, including those prohibited by the WTO, among others, on foreign direct investment; (iii) provide freedom to foreign direct investment projects regarding all investment-related transfers, e.g., profits, royalties, the right of compensation for confiscation, requisition, and other guarantees; (iv) provide for binding international arbitration for investor-State disputes; and (v) abide by international law standards for expropriation, i.e., expropriation only for a public purpose and with prompt, adequate and effective compensation.

\[1^{15}\] The general problem of the lack of a competitive business environment in Russia is analyzed in Broadman (2000).
2. Legislation should be enacted to substantially reduce over a phased period in a time-bound program both (i) the number of sectors where FDI is presently prohibited and (ii) the number and incidence of existing limitations on FDI in sectors where it is permitted but restricted. Such measures should cover not only manufacturing sectors but also the infrastructure monopolies sectors and services sectors.

3. The Government should refrain from creating – and not supporting legislative initiatives for establishing – new preferential measures, including policies in the areas of taxation, customs duties, among other instruments, for FDI, including the creation under law of new “priority” sectors or projects. At the same time, the Government should take all necessary actions, including seeking enactment of legislation where necessary, to ensure that all existing preferential instruments for current FDI projects are not renewed and thus terminate concurrently with existing contracts.

4. Enforcement of property rights should be strengthened.

5. Foreign investor registration procedures should be simplified, rules-based, and made transparent.

6. Guarantee schemes covering basic non-commercial risks should be maintained and extended.
A New Kind of Foreign Direct Investment. The last 10 or 15 years has seen the rise of a new kind of foreign direct investment (FDI). The two older, still-extant paradigms are (a) market-seeking, and (b) resource- or cost-reduction seeking. The new, third kind can be called (c) “globalizing,” and has the following characteristics:

- Especially within the manufacturing sector, most of it is not focused only on either local resources (i.e. cheap labor, climate, raw materials) or domestic markets, but rather is looking for a combination of both market access and cost-effective production. Much of it has significant shares of its sales both in export markets and in the market of the host country.

- A fair amount of it has been implemented in transactions in which mergers and acquisitions (M&A), including privatizations, played a major role -- rather than greenfield activity. This characteristic is especially marked in FDI among the developed countries and may be less common in the LDCs. Of course most M&A deals are followed by some greenfield; the distinction can get a bit fuzzy.

- None of it is “stand alone” – i.e. it is not an independent profit center that is permitted by the MNC headquarters to more or less do as it sees fit, independently of the rest of the organization, as long as it makes a profit. Rather, it is part of a strategic plan by one or more multinationals to optimize locations of various parts of one or more production chains that have production locations in various countries and markets in various (same and/or other) countries. This “plan” may be internal to one MNC, to get or maintain a competitive edge in some final or intermediate markets, or it may be a coordinated plan of more than one MNC, with some sort of strategic alliance, tacit or explicit, among them. The best single empirical distinguishing characteristic may be that the location decision in question depended on other location decisions.

- Labor intensive activities fall within this globalizing FDI if the labor in question is highly educated and highly skilled, and the activity is closely linked with other operations of the MNC. A lot of this is in what are *de facto* service activities, although some are in companies that are clearly service companies while other are service parts of manufacturing companies (e.g. engineering or software design of manufactured products). Thus, writing computer code in Bangalore or designing high-pressure boilers for electric power generation plants in China should be included.

Globalizing FDI will not go to second-best locations (however defined) because its companies operate under severe competitive pressures that in effect do not permit second-best locations. Since very little globalizing FDI is tied to any one country – although it may be tied to a region – it is free to avoid unfavorable locations. In operational terms, and in addition to the characteristics of a good investment environment that are described in the main text of this paper, globalizing FDI in particular wants:

- An absence of restrictions and requirements and harassment by government, especially on entry (i.e. establishment of foreign-invested firms), imports, exports, percentage foreign ownership, employment of expatriates, and local procurement. Restrictions both on establishment and on
operations are important; globalizing FDI requires flexibility to alter its mode of production, process, and sources of procurement, without having to get time-consuming or risky government permission.

- High-quality transportation and telecommunication links with the rest of the world.

- Some kind of minimal quality-of-life; e.g. absence of significant crime/corruption.

Both of the older kinds of FDI still operate and can be quite valuable for a country to attract. But the globalizing FDI is the main kind that serves dynamic markets, and is automatically high-productivity. It is therefore the most valuable kind to try to attract. World Bank (FIAS) research and experience suggest that only about a dozen developing and transition countries are attracting significant amounts of globalizing FDI.

The Case of Mexico. Throughout the 1950s, ‘60s and ‘70s the Mexican economy grew steadily, with exceptional macroeconomic stability and an import-substitution strategy. Its large market limited the inefficiencies inherent in this strategy, as did its long border with the United States, which kept protection levels below the extremes of some South American countries that also erected high barriers to import competition.

FDI came to Mexico mainly to serve the domestic market. High production costs, the result of both natural factors such as deficient infrastructure and poorly educated workers and also policy-imposed factors such as domestic procurement requirements, were passed on to Mexican consumers, and most foreign-invested companies did not export – indeed, they could not be competitive in export markets. The exception was the maquiladora industry, which began as simple labor-intensive assembly of garments and electrical assemblies; parts were imported from the US and products re-exported to the US, under a provision of US law that limited duties to the value added in Mexico.

Petroleum, petrochemicals, all infrastructure services, banking and finance, and many other sectors were closed to foreign investors. Except for the maquiladoras and the automotive industry, foreign investors were restricted to less than 50 percent ownership of a company (in some sectors, less than 40%), and this severely limited FDI in contrast to countries such as Brazil where no such limitations were imposed. The ownership restrictions were especially important impediments to high-tech, cutting edge technology, and globalizing FDI that needs to export, because multinationals do not want to share their best technology with foreign partners that are forced upon them, and cannot plan to supply export markets competitively if they cannot assure production at world standards of quality and price.

Increasing inflation in the 1970s, the first devaluation in 25 years in 1976, and the exhaustion of import substitution possibilities ended this era of stable growth. Explosive growth in hydrocarbon exports, which began in the 1970s, turned out to be more a curse than a blessing as Mexico’s fiscal and exchange rate policies were allowed to deteriorate in a wave of excessive overconfidence. With the debt crisis of 1982, the need for a new approach became acute and obvious to all.

Mexico implemented macroeconomic reforms beginning in August 1982 in order to reduce inflation, service its restructured debt, and stabilize the economy. The balance of payments problem was solved, in a static sense, very quickly although with much pain. But it soon became clear that to resume growth Mexico would need to complement these reforms by a more liberal trade and investment regime - consistent with the global operations of multinational firms, and indeed to provide the appropriate framework for Mexican-owned firms to attain international competitiveness as well. As the economy recovered in the mid-1980s, trade barriers were eliminated, both imports and exports rose, and FDI
became essential -- not only to finance the external deficit, but mainly to increase efficient export capacity and employment.

Following the trade liberalization in the mid-1980s, the first move to liberalize FDI came in 1989. By then it had become obvious that the most dynamic trade flows were generated by multinational firms who would specialize in the production of one or a few products, not only selling them in Mexico but also exporting them to the world. Such operations required the freedom to import, expand capacity, and change products or processes without restriction or even delays while awaiting government approval.

New regulations on foreign investment, issued in 1989, were drastic modifications in the restrictive law which dated from 1973. The regulations liberalized FDI establishment in several ways, and were complemented by liberalization of regulatory practice that was just as important, even though it was informal. Formally, majority Mexican equity was no longer required, except in a few sectors such as banking, oil, and electricity, if a proposed investment met certain criteria. In practice virtually every normal investment was deemed to meet these criteria, and permission was given automatically and quickly; the only exceptions were undesirable or truly sensitive activities such as toxic waste dumps, gambling casinos, weapons assembly, nuclear technology, etc. The regulations also simplified the registration procedures for foreign investors, and removed or simplified restrictions and red tape that had previously been involved in government approval of various aspects of technology transfers.

Foreign investments that were within the restrictions on percentage ownership had not, and still did not, need government approval – they were treated as Mexican companies in every way. But for foreign investments that wanted to exceed the limits, it had been possible, and still was possible, to request an exemption. This exemption was granted (or refused) by an inter-ministerial body called the National Foreign Investment Commission (Comision Nacional de Inversion Extranjera -- CNIE). Under the new regulations, the CNIE only had to rule over a much smaller number of exceptions to a much more liberal regime. Procedurally, the CNIE stopped its practice of detailed evaluation of requests for exemptions, with bargaining on conditions and, sometimes, refusal. Instead, it processed applications routinely and approved virtually every request, without imposing conditions, with the few exceptions noted above.

As to technology transfers, the former practice whereby the Ministry of Industry had to approve all contracts for technology transfers was abolished. The Ministry’s practice had been to evaluate these contracts and in many cases to substitute its judgment for that of the Mexican companies, both in regard to whether the particular technology was or was not appropriate, and in regard to the price paid (royalties, etc.). Mexican private companies, the supposed beneficiaries of this practice, were the loudest voices against it, and as of 1989 the practice was discontinued.

Overall, the change in Mexico’s attitude toward FDI went far beyond the change in regulations. The Government’s basic attitude switched from suspicion and regulation, to promotion and facilitation. As another part of the implementation of this change, the Government created a new autonomous agency, the Mexican Investment Board, to promote FDI in Mexico. Supported half by the government and half by the private sector, the MIB has the task of attracting desired investment to Mexico and facilitating the paper work of foreign investors with regulatory authorities, including those at the provincial government level.

These reforms, plus some recovery in domestic demand in the second half of the 1980s, brought increased FDI flows, but only in 1989 did the amount reach $3 billion and in 1990 it fell by 10 percent. Thus the government realized that its new FDI regulations and more liberal procedures were not enough
to attract foreign capital in large amounts. The next step was NAFTA, the free trade agreement with the US and Canada.

NAFTA negotiations started in 1991. For Mexico the main objective of this “free trade” agreement was in fact not free trade but rather to attract more world-class FDI. Mexico already had very good access to US markets, except for a few products where restrictions remained even under NAFTA.

The investment dimensions of this trade treaty were both explicit and implicit. Explicitly, NAFTA was the first trade agreement to contain wide and specific regulation on investment. In particular, the ‘national treatment principle’ commits the Government to guarantee to a North American investor treatment which is just as good as it gives to the national. NAFTA also removed restrictions in sectors which the 1989 regulations had left protected, such as car parts, banking, and electricity generation. Beyond these explicit provisions, NAFTA made it much more difficult for future Mexican governments to reverse the liberalizing reforms of the mid- and late-1980s. By locking in those reforms, the agreement greatly reduced uncertainty over the regulatory framework, as well as over market access to North America. This was another necessary dimension of a Mexican environment that would attract globalizing FDI.
Manufacturing is not the only part of the economy in which world-class production is important. Telecommunications service is crucial to provide an environment in which companies can achieve world-competitive costs, quality and time of delivery. Southwestern Bell Corp (SBC) of the USA wanted to invest in Mexico but was legally unable to own control in a local telephone company, even under the 1989 law. SBC nevertheless took a minority position in Telmex, the formerly government-owned and operated telecom monopoly that was being privatized, in 1990. SBC provided technology and finance to the newly privatized firm with an investment of $1 billion. This investment is an integral part of SBC's international operation and plans, which include France, South Africa, Switzerland and Brazil. Its recent acquisition of Ameritech indicates further impetus in the globalizing FDI, as Ameritech holds large international operations. There is little doubt that SBC would further expand its involvement in Mexico as communications between Mexico and the US expand, especially if remaining restrictions on local telephones are removed.

Similarly, the opening of the banking system to FDI in 1995, encouraged Citibank to be the first US bank to acquire a Mexican commercial bank, Confia. This acquisition, in the context of subsequent additional liberalizations of banking regulations, will enable Citibank to expand its deposit base and to provide a full range of world-class services to all clients in Mexico. Operations of Citibank and Confia are now part of the global system of credit management of Citibank.

FDI flows into Mexico started to increase again as investors anticipated the effects of NAFTA and continuing liberalization in Mexico. In 1991 the amount exceeded $4 billion for the first time, and has continued to rise since then. Much of this increase was in globalizing FDI, in response to the trade liberalization and the expectation of a successful NAFTA negotiation, but the expectation of growth in the Mexican market was also an important driving factor.

There were still important de facto obstacles to globalizing FDI coming to Mexico during the early 1990s. For greenfield investments (new, wholly-owned factories) the reforms were sufficient. But mergers, acquisitions, and joint ventures were still impeded by a combination of remaining legal restrictions in some key sectors and by informal mechanisms. Despite the change in regulatory practice in 1989, the reluctance of domestic investors to give up operational control to foreigners was partly an inheritance of past policies and practices. In addition, large Mexican conglomerates were strong, cash rich, had long experience with local markets, and were the beneficiaries of privatizations and close relations with the government. These factors kept the level of FDI below $5 billion per year, even though there was great expectation of successful NAFTA negotiations.

In 1993, with NAFTA approval in the near future and a more favorable political climate, the government codified both the regulations of 1989 and the coming NAFTA rules on FDI in a new FDI law. The old 1973 law was repealed. This new law made few de facto changes in the liberal climate that had prevailed since 1989, but by putting the new rules and practices in a law, rather than in regulations which could be more easily changed, reduced still further any uncertainty that investors might have about the future of the reforms.

Ironically, at the end of the same year that NAFTA was approved, 1994, risky monetary and credit policies by the outgoing Administration in Mexico precipitated another foreign debt crisis. One of the few good effects of this painful crisis was to accentuate the attractiveness of Mexico for globalizing FDI and to remove or reduce many of the most important remaining obstacles. The peso devaluation improved export profitability, while many producers of industrial materials wanted to be linked to a global network as a precondition to continue in operation. In non-tradables, however, profits fell and some foreign investors who had entered Mexico recently and who depended completely on Mexican consumer demand, pulled out. This was the case of retailers JC Penny and K-Mart, or franchises like Twinnings.
In 1995 and 1996 the Government liberalized FDI in natural gas distribution and the banking sector, even though these had remained restricted even after NAFTA. Foreign investors responded quickly. All of the recent regional gas distribution concessions to private enterprise include foreign parties in partnership with a local business, such as Repsol of Spain, Gas de France and Novo Industries of California. Gas deregulation gave additional impetus to the earlier liberalization in electricity generation, as the new generators will use gas as a fuel. In electricity both GE and Mitsubishi participated in the first two private generation projects, approved in 1996 and 1997.

The share of M&A increased sharply as many local firms faced losses from the peso devaluation and were unable to maintain operations without a link to foreign markets and global networks. At the same time, the government removed many of the remaining sectoral restrictions on foreign ownership, importantly in banking, gas, and electricity generation. Foreign investors came to control some of the firms in which they had entered initially with a minority stake, such as the retailer Cifra (now controlled by WalMart), Iusacell (a cellular telephone firm now controlled by Bell Atlantic) and many banks.

Much globalizing FDI went into maquiladoras, which left behind the simple assembly focus of their beginnings decades earlier and came to include quite a few complex, medium- or even high-tech manufacturing processes. It is estimated that 90% of maquila investment during the last few years is of the globalizing type. Although many existing plants still have a limited focus on assembling from largely foreign components, even they are gradually comprising more complex processes. One example is the large Delphi plants owned by GM, employing many Mexican engineers in product design. The standards of operation, quality, and efficiency of these plants are of the same or higher levels than those of their sister plants in North America. Other examples include AT&T, GM, Emerson Electric and Sony. This change towards sophisticated, integrated manufacturing anticipates the de facto end of the maquiladora status, as under NAFTA any exporter from Mexico to the US or Canada will benefit from the same privileges as do the maquiladoras, after a seven-year phase-out period that ends in 2001.

Large acquisitions, an intensification of globalizing manufacturing activity, and more deregulation thus explain the jump in FDI inflows from 1994 onwards. Most of this FDI was of the globalizing type.

Summary. A summary view of the policy changes described here, and the results in terms of FDI flows to Mexico, is presented in the Table 1. The story in its simplest form is that Mexico executed a series of reforms in three areas of policy, over a period of about 14 years (from 1982 to 1996):

- Monetary, fiscal, and exchange rate reforms, to stabilize the economy, began in 1982.
- Trade reforms, which liberalized imports (licensing was abolished and tariffs lowered) followed around 1985.
- Removal of restrictions on FDI began in 1989, with the freeing of more and more sectors from restrictions on the percentage of foreign ownership, abolition of TRIMS (notably, domestic content requirements), and the privatizations of former government monopolies and the opening of those sectors to FDI. NAFTA, negotiated during the early ’90s and implemented in 1994, increased and locked in all those reforms in both trade and foreign investment rules. Other regulations which restricted the freedom of foreign-invested firms to change their operations were also abolished or relaxed. Additional sectors were liberalized in 1995 and 1996.
The results have included a remarkable increase in the quantity of FDI inflows, rising from the levels around $2 billion per year in the late 1980s, to around $4 billion during the early 1990s and averaging $10 billion per year since 1994. But even these dramatic increases in amounts are perhaps less important than the changes in quality, as most of the additional FDI during the last five years has created world-class facilities that are competitive in price and quality with others all over the world, and that therefore can, and do, include Mexico as parts of the global strategies of multinational corporations. The days of high-cost, old technology factories producing for Mexican consumers only are gone, as are the days of manufactured exports consisting mostly of simple, low-value-added products based on cheap Mexican labor. Mexico today is more and more integrated in world-class production linkages, and this includes not only foreign-invested companies but also a growing number of purely Mexican firms that have also taken advantage of the changed policy framework.

### Table 1
Foreign Direct Investment in Mexico and Policy Changes: 1989-97
($ bn or percentages)

<table>
<thead>
<tr>
<th>Year</th>
<th>$ FDI Inflows</th>
<th>Approximate Shares (%)</th>
<th>Approximate Shares (%)</th>
<th>Estimated Shares (%) of globalizing FDI</th>
<th>Policy Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ FDI Inflows</td>
<td>M&amp;A</td>
<td>Greenfield</td>
<td>Tradable</td>
<td>Non-Tradable</td>
</tr>
<tr>
<td>1989</td>
<td>3.0</td>
<td>10</td>
<td>90</td>
<td>40</td>
<td>60</td>
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<tr>
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<td>2.6</td>
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<tr>
<td>1992</td>
<td>4.4</td>
<td>20</td>
<td>80</td>
<td>40</td>
<td>60</td>
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<td>4.4</td>
<td>30</td>
<td>70</td>
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<td>60</td>
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<tr>
<td>1994</td>
<td>11.0</td>
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<td>40</td>
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<td>80</td>
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<td>1997</td>
<td>12.1</td>
<td>60</td>
<td>40</td>
<td>85</td>
<td>15</td>
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</table>

Source: Bank of Mexico on FDI flows and FIAS’ estimates on shares.
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