OVERVIEW

FDI TRENDS AND PROSPECTS

Global FDI losing momentum in 2012

Global foreign direct investment (FDI) inflows rose 16 per cent in 2011, surpassing the 2005–2007 pre-crisis level for the first time, despite the continuing effects of the global financial and economic crisis of 2008–2009 and the ongoing sovereign debt crises. This increase occurred against a background of higher profits of transnational corporations (TNCs) and relatively high economic growth in developing countries during the year.

A resurgence in economic uncertainty and the possibility of lower growth rates in major emerging markets risks undercutting this favourable trend in 2012. UNCTAD predicts the growth rate of FDI will slow in 2012, with flows levelling off at about $1.6 trillion, the midpoint of a range. Leading indicators are suggestive of this trend, with the value of both cross-border mergers and acquisitions (M&As) and greenfield investments retreating in the first five months of 2012. Weak levels of M&A announcements also suggest sluggish FDI flows in the later part of the year.

Medium-term prospects cautiously optimistic

UNCTAD projections for the medium term based on macroeconomic fundamentals continue to show FDI flows increasing at a moderate but steady pace, reaching $1.8 trillion and $1.9 trillion in 2013 and 2014, respectively, barring any macroeconomic shocks. Investor uncertainty about the course of economic events for this period is still high. Results from UNCTAD's *World Investment Prospects Survey* (*WIPS*), which polls TNC executives on their investment plans, reveal that while respondents who are pessimistic about the global investment climate for 2012 outnumber those who are optimistic by 10 percentage points, the largest single group of respondents – roughly half – are either neutral or undecided. Responses for the medium term, after 2012, paint a gradually more optimistic picture. When asked about their planned future FDI expenditures, more than half of respondents foresee an increase between 2012 and 2014, compared with 2011 levels.

FDI inflows up across all major economic groupings

FDI flows to developed countries grew robustly in 2011, reaching $748 billion, up 21 per cent from 2010. Nevertheless, the level of their inflows was still a quarter below the level of the pre-crisis three-year average. Despite this increase, developing and transition economies together continued to account for more than half of global FDI (45 per cent and 6 per cent, respectively) for the year as their combined inflows reached a new record high, rising 12 per cent to $777 billion. Reaching high level of global FDI flows during the economic and financial crisis it speaks to the economic dynamism and strong role of these countries in future FDI flows that they maintained this share as developed economies rebounded in 2011.

Rising FDI to developing countries was driven by a 10 per cent increase in Asia and a 16 per cent increase in Latin America and the Caribbean. FDI to the transition economies increased by 25 per cent to $92 billion. Flows to Africa, in contrast, continued their downward trend for a third consecutive year, but the decline was marginal. The poorest countries remained in FDI recession, with flows to the least developed countries (LDCs) retreating 11 per cent to $15 billion.

Indications suggest that developing and transition economies will continue to keep up with the pace of growth in global FDI in the medium term. TNC executives responding to this year's WIPS ranked 6 developing and transition economies among their top 10 prospective destinations for the period ending in 2014, with Indonesia rising two places to enter the top five destinations for the first time.

The growth of FDI inflows in 2012 will be moderate in all three groups – developed, developing and transition economies. In developing regions, Africa is noteworthy as inflows are expected to recover. Growth in FDI is expected to be temperate in Asia (including East and South-East Asia, South Asia and West Asia) and Latin America. FDI flows to transition economies are expected to grow further in 2012 and exceed the 2007 peak in 2014.

Rising global FDI outflows driven by developed economies

FDI from developed countries rose sharply in 2011, by 25 per cent, to reach $1.24 trillion. While all three major developed-economy investor blocs – the European Union (EU), North America and Japan – contributed to this increase, the driving factors differed for each. FDI from the United States was driven by a record level of reinvested earnings (82 per cent of total FDI outflows), in part driven by TNCs building on their foreign cash holdings. The rise of FDI outflows from the EU was driven by cross-border M&As. An appreciating yen improved the purchasing power of Japanese TNCs, resulting in a doubling of their FDI outflows, with net M&A purchases in North America and Europe rising 132 per cent.

Outward FDI from developing economies declined by 4 per cent to $384 billion in 2011, although their share in global outflows remained high at 23 per cent. Flows from Latin America and the Caribbean fell 17 per cent, largely owing to the repatriation of capital to the region (counted as negative outflows) motivated in part by financial considerations (exchange rates, interest rate differentials). Flows from East and South-East Asia were largely stagnant (with an 9 per cent decline in those from East Asia), while outward FDI from West Asia increased significantly, to $25 billion.

M&As picking up but greenfield investment dominates

Cross-border M&As rose 53 per cent in 2011 to $526 billion, spurred by a rise in the number of megadeals (those with a value over $3 billion), to 62 in 2011, up from 44 in 2010. This reflects both the growing value of assets on stock markets and the increased financial capacity of buyers to carry out such operations. Greenfield investment projects, which had declined in value terms for two straight years, held steady in 2011 at $904 billion. Developing and transition economies continued to host more than two thirds of the total value of greenfield investments in 2011.

Although the growth in global FDI flows in 2011 was driven in large part by cross-border M&As, the total project value of greenfield investments remains significantly higher than that of cross-border M&As, as has been the case since the financial crisis.

Turnaround in primary and services-sector FDI

FDI flows rose in all three sectors of production (primary, manufacturing and services), according to FDI projects data (comprising cross-border M&As and greenfield investments). Services-sector FDI rebounded in 2011 after falling sharply in 2009 and 2010, to reach some $570 billion. Primary sector investment also reversed the negative trend of the previous two years, at $200 billion. The share of both sectors rose slightly at the expense of manufacturing. Overall, the top five industries contributing to the rise in FDI projects were extractive industries (mining, quarrying and petroleum), chemicals, utilities (electricity, gas and water), transportation and communications, and other services (largely driven by oil and gas field services).

SWFs show potential for investment in development

Compared with assets of nearly $5 trillion under management, FDI by sovereign wealth funds (SWFs) is still relatively small. By 2011, their cumulative FDI reached an estimated $125 billion, with more than a quarter of that in developing countries. However, with their long-term and strategically oriented investment outlook, SWFs appear well placed to invest in productive sectors in developing countries, particularly the LDCs. They offer the scale to be able to invest in infrastructure development and the upgrading of agricultural productivity – key to economic development in many LDCs – as well as in industrial development, including the build-up of green growth industries. To increase their investment in these areas, SWFs can work in partnership with host-country governments, development finance institutions or other private sector investors that can bring technical and managerial competencies to projects.

TNCs still hold back from investing record cash holdings

Foreign affiliates' economic activity rose in 2011 across all major indicators of international production. During the year, foreign affiliates employed an estimated 69 million workers, who generated $28 trillion in sales and $7 trillion in value added. Data from UNCTAD's annual survey of the largest 100 TNCs reflects the overall upward trend in international production, with the foreign sales and employment of these firms growing significantly faster than those in their home economy.

Despite the gradual advance of international production by TNCs, their record levels of cash have so far not translated into sustained growth in investment levels. UNCTAD estimates that these cash levels have reached more than $5 trillion, including earnings retained overseas. Data on the largest 100 TNCs show that during the global financial crisis they cut capital expenditures in productive assets and acquisitions (especially foreign acquisitions) in favour of holding cash. Cash levels for these 100 firms alone peaked in 2010 at $1.03 trillion, of which an estimated $166 billion was additional – above the levels suggested by average pre-crisis cash holdings. Although recent figures suggest that TNCs' capital expenditures in productive assets and acquisitions are picking up, rising 12 per cent in 2011, the additional cash they are holding – an estimated $105 billion in 2011 – is still not being fully deployed. Renewed instability in international financial markets will continue to encourage cash holding and other uses of cash such as paying dividends or reducing debt levels. Nevertheless, as conditions improve, the current cash "overhang" may fuel a future surge in FDI. Projecting the data for the top 100 TNCs over the estimated $5 trillion in total TNC cash holdings results in more than $500 billion in investable funds, or about one third of global FDI flows.

UNCTAD's FDI Attraction and Contribution Indices show developing countries moving up the ranks

The UNCTAD FDI Attraction Index, which measures the success of economies in attracting FDI (combining total FDI inflows and inflows relative to GDP), features 8 developing and transition economies in the top 10, compared with only 4 a decade ago. A 2011 newcomer in the top ranks is Mongolia. Just outside the top 10, a number of other countries saw significant improvements in their ranking, including Ghana (16), Mozambique (21) and Nigeria (23). Comparing the FDI Attraction Index with another UNCTAD index, the FDI Potential Index, shows that a number of developing and transition economies have managed to attract more FDI than expected, including Albania, Cambodia, Madagascar and Mongolia. Others have received less FDI than could be expected based on economic determinants, including Argentina, the Philippines, Slovenia and South Africa.

The UNCTAD FDI Contribution Index – introduced in *WIR12* – ranks economies on the basis of the significance of FDI and foreign affiliates in their economy, in terms of value added, employment, wages, tax receipts, exports, research and development (R&D) expenditures, and capital formation (e.g. the share of employment in foreign affiliates in total formal employment in each country, and so forth). These variables are among the most important indicators of the economic impact of FDI. According to the index, in 2011 the host economy with the largest contribution by FDI was Hungary followed by Belgium and the Czech Republic. The UNCTAD FDI Contribution Index shows relatively higher contributions of foreign affiliates to local economies in developing countries, especially Africa, in value added, employment, export generation and R&D expenditures.

Comparing the FDI Contribution Index with the weight of FDI stock in a country's GDP shows that a number of developing and transition economies get a higher economic development impact "per unit of FDI" than others, including Argentina, Bolivia and Colombia and, to a lesser degree, Brazil, China and Romania. In other cases, FDI appears to contribute less than could be expected by the volume of stock present in the country, as in Bulgaria, Chile and Jamaica. The latter group also includes a number of economies that attract significant investment largely because of their fiscal regime, but without the equivalent impact on the domestic economy.

RECENT TRENDS BY REGION

FDI to Africa continues to decline, but prospects are brightening

FDI inflows to Africa as a whole declined for the third successive year, to $42.7 billion. However, the decline in FDI inflows to the continent in 2011 was caused largely by the fall in North Africa; in particular, inflows to Egypt and Libya, which had been major recipients of FDI, came to a halt owing to their protracted political instability. In contrast, inflows to sub-Saharan Africa recovered from $29 billion in 2010 to $37 billion in 2011, a level comparable with the peak in 2008. A rebound of FDI to South Africa accentuated the recovery. The continuing rise in commodity prices and a relatively positive economic outlook for sub-Saharan Africa are among the factors contributing to the turnaround. In addition to traditional patterns of FDI to the extractive industries, the emergence of a middle class is fostering the growth of FDI in services such as banking, retail and telecommunications, as witnessed by an increase in the share of services FDI in 2011.

The overall fall in FDI to Africa was due principally to a reduction in flows from developed countries, leaving developing countries to increase their share in inward FDI to the continent (from 45 per cent in 2010 to 53 per cent in 2011 in greenfield investment projects).

South-East Asia is catching up with East Asia

In the developing regions of East Asia and South-East Asia, FDI inflows reached new records, with total inflows amounting to $336 billion, accounting for 22 per cent of global inflows. South-East Asia, with inflows of $117 billion, up 26 per cent, continued to experience faster FDI growth than East Asia, although the latter was still dominant at $219 billion, up 9 per cent. Four economies of the Association of South-East Asian Nations (ASEAN) – Brunei Darussalam, Indonesia, Malaysia and Singapore – saw a considerable rise.

FDI flows to China also reached a record level of $124 billion, and flows to the services sector surpassed those to manufacturing for the first time. China continued to be in the top spot as investors' preferred destination for FDI, according to UNCTAD's *WIPS*, but the rankings of South-East Asian economies such as Indonesia and Thailand have risen markedly. Overall, as China continues to experience rising wages and production costs, the relative competitiveness of ASEAN countries in manufacturing is increasing.

FDI outflows from East Asia dropped by 9 per cent to $180 billion, while those from South-East Asia rose 36 per cent to $60 billion. Outflows from China dropped by 5 per cent, while those from Hong Kong, China, declined by 15 per cent. By contrast, outflows from Singapore registered a 19 per cent increase and outflows from Indonesia and Thailand surged.

Rising extractive industry M&As boost FDI in South Asia

In South Asia, FDI inflows have turned around after a slide in 2009–2010, reaching $39 billion, mainly as a result of rising inflows in India, which accounted for more than four fifths of the region's FDI. Cross-border M&A sales in extractive industries surged to $9 billion, while M&A sales in manufacturing declined by about two thirds, and those in services remained much below the annual amounts witnessed during 2006–2009.

Countries in the region face different challenges, such as political risks and obstacles to FDI, that need to be tackled in order to build an attractive investment climate. Nevertheless, recent developments such as the improving relationship between India and Pakistan have highlighted new opportunities.

FDI outflows from India rose by 12 per cent to $15 billion. A drop in cross-border M&As across all three sectors was compensated by a rise in overseas greenfield projects, particularly in extractive industries, metal and metal products, and business services.

Regional and global crises still weigh on FDI in West Asia

FDI inflows to West Asia declined for the third consecutive year, to $49 billion in 2011. Inflows to the Gulf Cooperation Council (GCC) countries continued to suffer from the effects of the cancellation of large-scale investment projects, especially in construction, when project finance dried up in the wake of the global financial crisis, and were further affected by the unrest across the region during 2011. Among non-GCC countries the growth of FDI flows was uneven. In Turkey they were driven by a more than three-fold increase in cross-border M&A sales. Spreading political and social unrest has directly and indirectly affected FDI inflows to the other countries in the region.

FDI outflows recovered in 2011 after reaching a five-year low in 2010, indicating a return to overseas acquisitions by investors based in the region (after a period of divestments). It was driven largely by an increase in overseas greenfield projects in the manufacturing sector.

Latin America and the Caribbean: shift towards industrial policy

FDI inflows to Latin America and the Caribbean increased by 16 per cent to $217 billion, driven mainly by higher flows to South America (up 34 per cent). Inflows to Central America and the Caribbean, excluding offshore financial centres, increased by 4 per cent, while those to the offshore financial centres registered a 4 per cent decrease. High FDI growth in South America was mainly due to its expanding consumer markets, high growth rates and natural-resource endowments.

Outflows from the region have become volatile since the beginning of the global financial crisis. They decreased by 17 per cent in 2011, after a 121 per cent increase in 2010, which followed a 44 per cent decline in 2009. This volatility is due to the growing importance of flows that are not necessarily related to investment in productive activity abroad, as reflected by the high share of offshore financial centres in total FDI from the region, and the increasing repatriation of intracompany loans by Brazilian outward investors ($21 billion in 2011).

A shift towards a greater use of industrial policy is occurring in some countries in the region, with a series of measures designed to build productive capacities and boost the manufacturing sector. These measures include higher tariff barriers, more stringent criteria for licenses and increased preference for domestic production in public procurement. These policies may induce "barrier hopping" FDI into the region and appear to have had an effect on firms' investment plans. TNCs in the automobile, computer and agriculturemachinery industries have announced investment plans in the region. These investments are by traditional European and North American investors in the region, as well as TNCs from developing countries and Japan.

FDI prospects for transition economies helped by the Russian Federation's WTO accession

In economies in transition in South-East Europe, the Commonwealth of Independent States (CIS) and Georgia, FDI recovered some lost ground after two years of stagnant flows, reaching $92 billion, driven in large part by cross-border M&A deals. In South-East Europe, manufacturing FDI increased, buoyed by competitive production costs and open access to EU markets. In the CIS, resource-based economies benefited from continued natural-resource-seeking FDI. The Russian Federation continued to account for the lion's share of inward FDI to the region and saw FDI flows grow to the third highest level ever. Developed countries, mainly EU members, remained the most important source of FDI, with the highest share of projects (comprising cross-border M&As and greenfield investments), although projects by investors from developing and transition economies gained importance.

The services sector still plays only a small part in inward FDI in the region, but its importance may increase with the accession to the World Trade Organization (WTO) of the Russian Federation. Through WTO accession the country has committed to reduce restrictions on foreign investment in a number of services industries (including banking, insurance, business services, telecommunications and distribution). The accession may also boost foreign investors' confidence and improve the overall investment environment.

UNCTAD projects continued growth of FDI flows to transition economies, reflecting a more investor-friendly environment, WTO accession by the Russian Federation and new privatization programmes in extractive industries, utilities, banking and telecommunications.

Developed countries: signs of slowdown in 2012

Inflows to developed countries, which bottomed out in 2009, accelerated their recovery in 2011 to reach $748 billion, up 21 per cent from the previous year. The recovery since 2010 has nonetheless made up only one fifth of the ground lost during the financial crisis in 2008–2009. Inflows remained at 77 per cent of the pre-crisis three-year average (2005–2007). Inflows to Europe, which had declined until 2010, showed a turnaround while robust recovery of flows to the United States continued. Australia and New Zealand attracted significant volumes. Japan saw a net divestment for the second successive year.

Developed countries rich in natural resources, notably Australia, Canada and the United States, attracted FDI in oil and gas, particularly for unconventional fossil fuels, and in minerals such as coal, copper and iron ore. Financial institutions continued offloading overseas assets to repay the State aid they received during the financial crisis and to strengthen their capital base so as to meet the requirements of Basel III.

The recovery of FDI in developed regions will be tested severely in 2012 by the eurozone crisis and the apparent fragility of the recovery in most major economies. M&A data indicate that cross-border acquisitions of firms in developed countries in the first three months of 2012 were down 45 per cent compared with the same period in 2011. Announcement-based greenfield data show the same tendency (down 24 per cent). While UNCTAD's 2012 projections suggest inflows holding steady in North America and managing a modest increase in Europe, there are significant downside risks to these forecasts.

LDCs in FDI recession for the third consecutive year

In the LDCs, large divestments and repayments of intracompany loans by investors in a single country, Angola, reduced total group inflows to the lowest level in five years, to $15 billion. More significantly, greenfield investments in the group as a whole declined, and large-scale FDI projects remain concentrated in a few resource-rich LDCs.

Investments in mining, quarrying and petroleum remained the dominant form of FDI in LDCs, although investments in the services sector are increasing, especially in utilities, transport and storage, and telecommunication. About half of greenfield investments came from other developing economies, although neither the share nor the value of investments from these and transition economies recovered to the levels of 2008–2009. India remained the largest investor in LDCs from developing and transition economies, followed by China and South Africa.

In landlocked developing countries (LLDCs), FDI grew to a record high of $34.8 billion. Kazakhstan continued to be the driving force of FDI inflows. In Mongolia, inflows more than doubled because of large-scale projects in extractive industries. The vast majority of inward flows continued to be greenfield investments in mining, quarrying and petroleum. The share of investments from transition economies soared owing to a single large-scale investment from the Russian Federation to Uzbekistan. Together with developing economies, their share in greenfield projects reached 60 per cent in 2011.

In small island developing States (SIDS), FDI inflows fell for the third year in a row and dipped to their lowest level in six years at $4.1 billion. The distribution of flows to the group remained highly skewed towards tax-friendly jurisdictions, with three economies (the Bahamas, Trinidad and Tobago, and Barbados) receiving the bulk. In the absence of megadeals in mining, quarrying and petroleum, the total value of cross-border M&A sales in SIDS dropped significantly in 2011. In contrast, total greenfield investments reached a record high, with South Africa becoming the largest source. Three quarters of greenfield projects originated in developing and transition economies.

INVESTMENT POLICY TRENDS

National policies: investment promotion intensifies in crisis

Against a backdrop of continued economic uncertainty, turmoil in financial markets and slow growth, countries worldwide continued to liberalize and promote foreign investment as a means to support economic growth and development. At the same time, regulatory activities with regard to FDI continued.

Investment policy measures undertaken in 2011 were generally favourable to foreign investors. Compared with 2010, the percentage of more restrictive policy measures showed a significant decrease, from approximately 32 per cent to 22 per cent. It would, however, be premature to interpret this decrease as an indication of a reversal of the trend towards a more stringent policy environment for investment that has been observed in previous years – also because the 2011 restrictive measures add to the stock accumulated in previous years. The share of measures introducing new restrictions or regulations was roughly equal between the developing and transition economies and the developed countries.

The overall policy trend towards investment liberalization and promotion appears more and more to be targeted at specific industries, in particular some services industries (e.g. electricity, gas and water supply; transport and communication). Several countries pursued privatization policies. Other important measures related to the facilitation of admission procedures for foreign investment.

As in previous years, extractive industries proved the main exception inasmuch as most policy measures related to this industry were less favourable. Agribusiness and financial services were the other two industries with a relatively high share of less favourable measures.

More State regulation became manifest primarily in two policy areas: (i) an adjustment of entry policies with regard to inward FDI by introducing new entry barriers or by reinforcing screening procedures (in e.g. agriculture, pharmaceuticals) and (ii) more regulatory policies in extractive industries, including nationalization, expropriation or divestment requirements as well as increases in corporate taxation rates, royalties and contract renegotiations. Both policy types were partly driven by industrial policy considerations.

In 2011–2012, several countries took a more critical approach towards outward FDI. In light of high domestic unemployment, concerns are rising that outward FDI may contribute to job exports and a weakening of the domestic industrial base. Other policy objectives include foreign exchange stability and an improved balance of payments. Policy measures undertaken included outward FDI restrictions and incentives to repatriate foreign investment.

IIAs: regionalism on the rise

By the end of 2011, the overall IIA universe consisted of 3,164 agreements, which include 2,833 bilateral investment treaties (BITs) and 331 "other IIAs", including, principally, free trade agreements (FTAs) with investment provisions, economic partnership agreements and regional agreements (*WIR12* no longer includes double taxation treaties among IIAs). With a total of 47 IIAs signed in 2011 (33 BITs and 14 other IIAs), compared with 69 in 2010, traditional investment treaty making continued to lose momentum. This may have several causes, including (i) a gradual shift towards regional treaty making, and (ii) the fact that IIAs are becoming increasingly controversial and politically sensitive.

In quantitative terms, bilateral agreements still dominate; however, in terms of economic significance, regionalism becomes more important. The increasing economic weight and impact of regional treaty making is evidenced by investment negotiations under way for the Trans-Pacific Partnership (TPP) Agreement; the conclusion of the 2012 trilateral investment agreement between China, Japan and the Republic of Korea; the Mexico–Central America FTA, which includes an investment chapter; the fact that at the EU level the European Commission now negotiates investment agreements on behalf of all EU member States; and developments in ASEAN.

In most cases, regional treaties are FTAs. By addressing comprehensively the trade and investment elements of international economic activities, such broader agreements often respond better to today's economic realities, in which international trade and investment are increasingly interconnected (see *WIR11*). While this shift can bring about the consolidation and harmonization of investment rules and represent a step towards multilateralism, where the new treaties do not entail the phase-out of the old ones, the result can also be the opposite. Instead of simplification and growing consistency, regionalization may lead to a multiplication of treaty layers, making the IIA network even more complex and prone to overlaps and inconsistencies.

Sustainable development: increasingly recognized

While some IIAs concluded in 2011 keep to the traditional treaty model that focuses on investment protection as the sole aim of the treaty, others include innovations. Some new IIAs include a number of features to ensure that the treaty does not interfere with, but instead contributes to countries' sustainable development strategies that focus on the environmental and social impact of investment.

A number of other recent developments also indicate increased attention to sustainable development considerations. They include the 2012 revision of the United States Model BIT; the 2012 Joint Statement by the European Union and the United States, issued under the auspices of the Transatlantic Economic Council; and the work by the Southern African Development Community (SADC) on its model BIT.

Finally, increased attention to sustainable development also manifested itself in other international policymaking related to investment, e.g. the adoption of and follow-up work on the 2011 UN Guiding Principles on Business and Human Rights; the implementation of the UNCTAD/FAO/World Bank/IFAD Principles for Responsible Agricultural Investment; the 2011 Revision of the OECD Guidelines for Multinational Enterprises (1976); the 2012 Revision of the International Chamber of Commerce Guidelines for International Investment (1972); the Doha Mandate adopted at UNCTAD's XIII Ministerial Conference in 2012; and the Rio+20 Conference in 2012.

ISDS reform: unfinished agenda

In 2011, the number of known investor–State dispute settlement (ISDS) cases filed under IIAs grew by at least 46. This constitutes the highest number of known treaty-based disputes ever filed within one year. In some recent cases, investors challenged core public policies that had allegedly negatively affected their business prospects.

Some States have been expressing their concerns with today's ISDS system (e.g. Australia's trade-policy statement announcing that it would stop including ISDS clauses in its future IIAs; Venezuela's recent notification that it would withdraw from the ICSID Convention). These reflect, among others, deficiencies in the system (e.g. the expansive or contradictory interpretations of key IIA provisions by arbitration tribunals, inadequate enforcement and annulment procedures, concerns regarding the qualification of arbitrators, the lack of transparency and high costs of the proceeding, and the relationship between ISDS and State–State proceedings) and a broader public discourse about the usefulness and legitimacy of the ISDS mechanism.

Based on the perceived shortcomings of the ISDS system, a number of suggestions for reform are emerging. They aim at reigning in the growing number of ISDS cases, fostering the legitimacy and increasing the transparency of ISDS proceedings, dealing with inconsistent readings of key provisions in IIAs and poor treaty interpretation, improving the impartiality and quality of arbitrators, reducing the length and costs of proceedings, assisting developing countries in handling ISDS cases, and addressing overall concerns about the functioning of the system.

While some countries have already incorporated changes into their IIAs, many others continue with business as usual. A systematic assessment of individual reform options and their feasibility, potential effectiveness and implementation methods (e.g. at the level of IIAs, arbitral rules or institutions) remains to be done. A multilateral policy dialogue on ISDS could help to develop a consensus about the preferred course for reform and ways to put it into action.

Suppliers need support for CSR compliance

Since the early 2000s, there has been a significant proliferation of CSR codes in global supply chains, including both individual TNC codes and industry-level codes. It is now common across a broad range of industries for TNCs to set supplier codes of conduct detailing the social and environmental performance standards for their global supply chains. Furthermore, CSR codes and standards themselves are becoming more complex and their implementation more complicated.

CSR codes in global supply chains hold out the promise of promoting sustainable and inclusive development in host countries, transferring knowledge on addressing critical social and environmental issues, and opening new business opportunities for domestic suppliers meeting these standards. However, compliance with such codes also presents considerable challenges for many suppliers, especially small and medium-sized enterprises (SMEs) in developing countries. They include, inter alia, the use of international standards exceeding the current regulations and common market practices of host countries; the existence of diverging and sometimes conflicting requirements from different TNCs; the capacity constraints of suppliers to apply international standards in day-to-day operations and to deal with complex reporting requirements and multiple on-site inspections; consumer and civil society concerns; and competitiveness concerns for SMEs that bear the cost of fully complying with CSR standards relative to other SMEs that do not attempt to fully comply.

Meeting these challenges will require an upgrade of entrepreneurial and management skills. Governments, as well as TNCs, can assist domestic suppliers, in particular SMEs, through entrepreneurship-building and capacity-development programmes and by strengthening existing national institutions that promote compliance with labour and environmental laws. Policymakers can also support domestic suppliers by working with TNCs to harmonize standards at the industry level and to simplify compliance procedures.

UNCTAD'S INVESTMENT POLICY FRAMEWORK FOR SUSTAINABLE DEVELOPMENT

A new generation of investment policies emerges

Cross-border investment policy is made in a political and economic context that, at the global and regional levels, has been buffeted in recent years by a series of crises in finance, food security and the environment, and that faces persistent global imbalances and social challenges, especially with regard to poverty alleviation. These crises and challenges are having profound effects on the way policy is shaped at the global level. First, current crises have accentuated a longer-term shift in economic weight from developed countries to emerging markets. Second, the financial crisis in particular has boosted the role of governments in the economy, in both the developed and the developing world. Third, the nature of the challenges, which no country can address in isolation, makes better international coordination imperative. And fourth, the global political and economic context and the challenges that need to be addressed – with social and environmental concerns taking centre stage – are leading policymakers to reflect on an emerging new development paradigm that places inclusive and sustainable development goals on the same footing as economic growth. At a time of such persistent crises and pressing social and environmental challenges, mobilizing investment and ensuring that it contributes to sustainable development objectives is a priority for all countries.

Against this background, a new generation of foreign investment policies is emerging, with governments pursuing a broader and more intricate development policy agenda, while building or maintaining a generally favourable investment climate. This new generation of investment policies has been in the making for some time and is reflected in the dichotomy in policy directions over the last few years – with simultaneous moves to further liberalize investment regimes and promote foreign investment, on the one hand, and to regulate investment in pursuit of public policy objectives, on the other. It reflects the recognition that liberalization, if it is to generate sustainable development outcomes, has to be accompanied – if not preceded – by the establishment of proper regulatory and institutional frameworks.

"New generation" investment policies place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment. Although these concepts are not new in and by themselves, to date they have not been systematically integrated in mainstream investment policymaking. "New generation" investment policies aim to operationalize sustainable development in concrete measures and mechanisms at the national and international levels, and at the level of policymaking and implementation.

Broadly, "new generation" investment policies strive to:

- create synergies with wider economic development goals or industrial policies, and achieve seamless *integration in development strategies*;
- foster *responsible investor behaviour* and incorporate principles of CSR;
- ensure *policy effectiveness* in their design and implementation and in the institutional environment within which they operate.

New generation investment policies: new challenges

These three broad aspects of "new generation" foreign investment policies translate into specific investment policy challenges at the national and international levels (tables 1 and 2).

Table 1. National investment policy challenges

Integrating investment policy in development strategy	• Channeling investment to areas key for the build-up of productive capacity and international competitiveness • Ensuring coherence with the host of policy areas geared towards overall development objectives
Incorporating sustainable development objectives in investment policy	• Maximizing positive and minimizing negative impacts of investment • Fostering responsible investor behaviour
Ensuring investment policy relevance and effectiveness	• Building stronger institutions to implement investment policy • Measuring the sustainable development impact of investment

Source: UNCTAD, *World Investment Report 2012*.

Table 2. International investment policy challenges

Strengthening the development dimension of IIAs	• Safeguarding policy space for sustainable development needs • Making investment promotion provisions more concrete and consistent with sustainable development objectives
Balancing rights and obligations of states and investors	• Reflecting investor responsibilities in IIAs • Learning from and building on CSR principles
Managing the systemic complexity of the IIA regime	• Dealing with gaps, overlaps and inconsistencies in IIA coverage and content and resolving institutional and dispute settlement issues • Ensuring effective interaction and coherence with other public policies (e.g. climate change, labour) and systems (e.g. trading, financial)

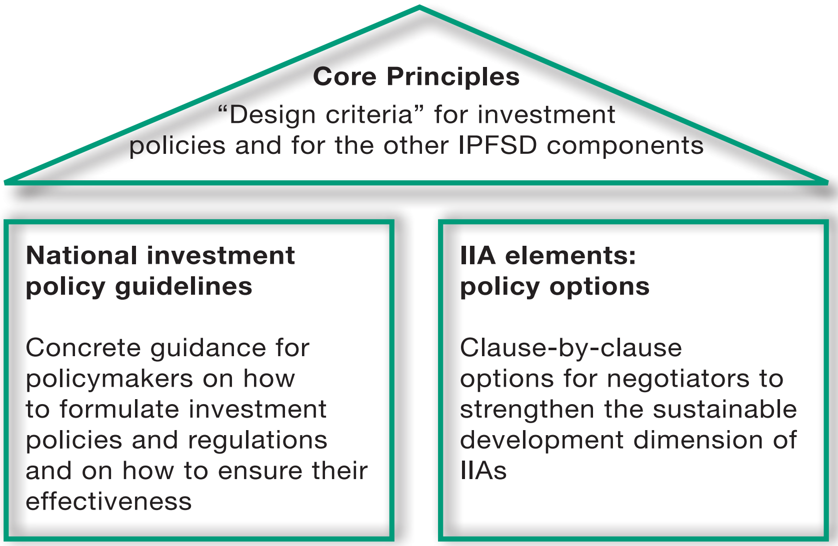
Source: UNCTAD, *World Investment Report 2012*.

Addressing the challenges: UNCTAD's IPFSD

To address these challenges, UNCTAD has developed a comprehensive Investment Policy Framework for Sustainable Development (IPFSD), consisting of (i) a set of Core Principles for foreign investment policymaking, (ii) guidelines for investment policies at the national level and (iii) options for the design and use of IIAs (figure 1).

UNCTAD's IPFSD is meant to provide guidance on cross-border investment policies, with a particular focus on FDI, although many of the guidelines in the section on national investment policies could also have relevance for domestic investment. Policies covered include those with regard to the establishment, treatment and promotion of investment; in addition, a comprehensive framework needs to look beyond investment policies per se and include investment-related aspects of other policy areas. Investment policies

Figure 1. Structure and components of the IPFSD



Source: UNCTAD, *World Investment Report 2012*.

covered comprise national and international policies, because coherence between the two is fundamental. The IPFSD focuses on direct investment in productive assets; portfolio investment is considered only where explicitly stated in the context of IIAs.

Although a number of existing international instruments provide guidance to investment policymakers, UNCTAD's IPFSD distinguishes itself in several ways. First, it is meant as a comprehensive instrument for dealing with all aspects of policymaking at the national and international levels. Second, it puts a particular emphasis on the relationship between foreign investment and sustainable development, advocating a balanced approach between the pursuit of purely economic growth objectives by means of investment liberalization and promotion, on the one hand, and the need to protect people and the environment, on the other hand. Third, it underscores the interests of developing countries in investment policymaking. Fourth, it is neither a legally binding text nor a voluntary undertaking between States, but expert guidance by an international organization, leaving policymakers free to "adapt and adopt" as appropriate, taking into account that one single policy framework cannot address the specific investment policy challenges of individual countries.

The IPFSD's Core Principles: "design criteria"

The Core Principles for investment policymaking aim to guide the development of national and international investment policies. To this end, they translate the policy challenges into a set of "design criteria" for investment policies (table 3). Overall, they aim to mainstream sustainable development in investment policymaking, while confirming the basic principles of sound development-oriented investment policies, in a balanced approach.

The Core Principles are not a set of rules per se. They are an integral part of the IPFSD, which attempts to convert them, collectively and individually, into concrete guidance for national investment policymakers and options for negotiators of IIAs. As such, they do not always follow the traditional policy areas of a national investment policy framework, nor the usual articles of IIAs. The overarching concept behind the principles is sustainable development; the principles should be read as a package, because interaction between them is fundamental to the IPFSD's balanced approach.

Table 3. Core Principles for investment policymaking for sustainable development

Area	Core Principles
1 **Investment for sustainable development**	• The overarching objective of investment policymaking is to promote investment for inclusive growth and sustainable development.
2 **Policy coherence**	• Investment policies should be grounded in a country's overall development strategy. All policies that impact on investment should be coherent and synergetic at both the national and international levels.
3 **Public governance and institutions**	• Investment policies should be developed involving all stakeholders, and embedded in an institutional framework based on the rule of law that adheres to high standards of public governance and ensures predictable, efficient and transparent procedures for investors.
4 **Dynamic policymaking**	• Investment policies should be regularly reviewed for effectiveness and relevance and adapted to changing development dynamics.
5 **Balanced rights and obligations**	• Investment policies should be balanced in setting out rights and obligations of States and investors in the interest of development for all.
6 **Right to regulate**	• Each country has the sovereign right to establish entry and operational conditions for foreign investment, subject to international commitments, in the interest of the public good and to minimize potential negative effects.
7 **Openness to investment**	• In line with each country's development strategy, investment policy should establish open, stable and predictable entry conditions for investment.
8 **Investment protection and treatment**	• Investment policies should provide adequate protection to established investors. The treatment of established investors should be non-discriminatory.
9 **Investment promotion and facilitation**	• Policies for investment promotion and facilitation should be aligned with sustainable development goals and designed to minimize the risk of harmful competition for investment.
10 **Corporate governance and responsibility**	• Investment policies should promote and facilitate the adoption of and compliance with best international practices of corporate social responsibility and good corporate governance.
11 **International cooperation**	• The international community should cooperate to address shared investment-for-development policy challenges, particularly in least developed countries. Collective efforts should also be made to avoid investment protectionism.

Source: UNCTAD, *World Investment Report 2012*.

The design of the Core Principles has been inspired by various sources of international law and politics. They can be traced back to a range of existing bodies of international law, treaties and declarations, including the UN Charter, the UN Millennium Development Goals, the "Monterrey Consensus", the UN Johannesburg Plan of Implementation and the Istanbul Programme of Action for the LDCs. Importantly, the 2012 UNCTAD XIII Conference recognized the role of FDI in the development process and called on countries to design policies aimed at enhancing the impact of foreign investment on sustainable development and inclusive growth, while underlining the importance of stable, predictable and enabling investment climates.

From Core Principles to national policy guidelines

The IPFSD's national investment policy guidelines translate the Core Principles for investment policymaking into numerous concrete and detailed guidelines that aim to address the "new generation" challenges for policymakers at the domestic level (see table 1 for the challenges). Table 4 provides an overview of (selected) distinguishing features of the IPFSD's national investment policy guidelines, with a specific focus on the sustainable development dimension.

Table 4. Sustainable development features of the National Investment Policy Guidelines

Challenges	IPFSD National Investment Policy Guidelines – *selected features*
Integrating investment policy in development strategy	• Dedicated section (section 1) on *strategic investment priorities* and investment policy *coherence for productive capacity building*, including sub-sections on investment and: - Human resource development - Infrastructure (including section on public-private partnerships) - Technology dissemination - Enterprise development (including promoting linkages) • Attention to investment policy options for the *protection of sensitive industries* (sub-section 2.1) • Sections on other policy areas geared towards overall sustainable development objectives to ensure *coherence* with investment policy (section 3)
Incorporating sustainable development objectives in investment policy	• Specific guidelines for the design of investment-specific policies and regulations (section 2), including not only establishment and operations, treatment and protection of investments, and investment promotion and facilitation, but also *investor responsibilities* (as well as a dedicated sub-section on corporate responsibility, sub-section 3.7) • Guidance on the encouragement of *responsible investment* and on guaranteeing compliance with *international core standards* (sub-section 2.3) • Guidance on investment promotion and use of incentives in the *interest of inclusive and sustainable development* (sub-section 2.4) • Specific guidelines aimed at *minimizing potential negative effects of investment*, such as: - Addressing tax avoidance (sub-section 3.2) - Preventing anti-competitive behaviour (sub-sections 3.4 and 3.9) - Guaranteeing core labour standards (sub-section 3.5) - Assessing and improving environmental impact (sub-section 3.8) • A sub-section on access to land, incorporating the *Principles for Responsible Agricultural Investment* (PRAI) (sub-section 3.6)
Ensuring investment policy relevance and effectiveness	• Dedicated section on *investment policy effectiveness* (section 4), including guidance on public governance and institutional capacity-building • Guidance on the measurement of policy *effectiveness* (sub-section 4.3) and the effectiveness of specific measures (e.g. incentives), with reference to: - Specific quantitative investment impact indicators - Dedicated UNCTAD tools (FDI Attraction and Contribution Indices)

Source: UNCTAD, *World Investment Report 2012*. Detailed guidelines are also available in the online version of the IPFSD at www.unctad.org/DIAE/IPFSD.

The sustainable development features of the national policy guidelines imply that governments have the policy space to consider and adopt relevant measures. Such policy space may be restricted by international commitments. It is therefore essential to consider the IPFSD's national investment policy guidelines and its guidance for the design of IIAs as an integrated whole. Coherence between national and international investment policies is crucial, with a view to, among others, avoiding policy discrepancies and investor–State disputes.

The national investment policy guidelines argue for policy action at the *strategic, normative*, and *administrative levels*.

At the *strategic* level, the IPFSD's national investment policy guidelines suggest that policymakers should ground investment policy in a broad road map for economic growth and sustainable development – such as those set out in formal economic or industrial development strategies in many countries. These strategies necessarily vary by country, depending on its stage of development, domestic endowments and individual preferences.

Defining the role of public, private, domestic and especially foreign direct investment in development strategy is important. Mobilizing investment for sustainable development remains a major challenge for developing countries, particularly for LDCs. Given the often huge development financing gaps in these countries, foreign investment can provide a necessary complement to domestic investment, and it can be particularly beneficial when it interacts in a synergetic way with domestic public and private investment.

At this level it is also important to develop policies to harness investment for productive capacity-building and to enhance international competitiveness, especially where investment is intended to play a central role in industrial upgrading and structural transformation in developing economies. Critical elements of productive capacity-building include human resources and skills development, technology and know-how, infrastructure development, and enterprise development. It is crucial to ensure coherence between investment policies and other policy areas geared towards overall development objectives.

At the *normative* level, IPFSD's national investment policy guidelines propose that through the setting of rules and regulations, on investment and in a range of other policy areas, policymakers should promote and regulate investment that is geared towards sustainable development goals.

Positive development impacts of FDI do not always materialize automatically. And the effect of FDI can also be negative. Reaping the development benefits from investment requires not only an enabling policy framework that provides clear, unequivocal and transparent rules for the entry and operation of foreign investors, it also requires adequate regulation to minimize any risks associated with investment. Such regulations need to cover policy areas beyond investment policies per se, such as trade, taxation, intellectual property, competition, labour market regulation, environmental policies and access to land.

Although laws and regulations are the basis of investor responsibility, voluntary CSR initiatives and standards have proliferated in recent years, and they are increasingly influencing corporate practices, behaviour and investment decisions. Governments can build on them to complement the regulatory framework and maximize the development benefits of investment.

At the *administrative* level, the guidelines make the point that through appropriate implementation and institutional mechanisms, policymakers should ensure the continued relevance and effectiveness of investment policies. Policies to address implementation issues should be an integral part of the investment strategy and should strive to achieve both integrity across government and regulatory institutions and a service orientation where warranted.

Measuring policy effectiveness is a critical aspect of investment policymaking. Investment policy should be based on a set of explicitly formulated policy objectives with clear priorities and a time frame for achieving them. These objectives should be the principal yard-stick for measuring policy effectiveness. Assessment of progress in policy implementation and verification of the application of rules and regulations at all administrative levels is at least as important as the measurement of policy effectiveness.

Objectives of investment policy should ideally include a number of quantifiable goals for both the *attraction* of investment and its *development contribution*. UNCTAD has developed – and field-tested – a number of indicators that can be used by policymakers for this purpose. In addition, UNCTAD's Investment Contribution Index can also serve as a starting point (see figure 4 above). To measure policy effectiveness for the *attraction* of investment, UNCTAD's Investment Potential and Attraction Matrix can be a useful tool.

The IPFSD's guidance on IIAs: design options

The guidance on international investment policies set out in UNCTAD's IPFSD translates the Core Principles into options for policymakers, with an analysis of sustainable development implications. While national investment policymakers address these challenges through rules, regulations, institutions and initiatives, at the international policy level this is done through a complex web of IIAs (including, principally, BITs, FTAs with investment provisions, economic partnership agreements and regional integration agreements). The complexity of that web, which leads to gaps, overlaps and inconsistencies in the system of IIAs, is itself one of the challenges to be addressed. The others include the need to strengthen the development dimension of IIAs, balancing the rights and obligations of States and investors, ensuring sufficient policy space for sustainable development policies and making investment promotion provisions more concrete and aligned with sustainable development objectives.

International investment policy challenges must be addressed at three levels:

- When formulating their *strategic approach* to IIAs, policymakers need to embed international investment policymaking into their countries' development strategies. This involves managing the interaction between IIAs and national policies (e.g. ensuring that IIAs support industrial policies) and that between IIAs and other international policies or agreements (e.g. ensuring that IIAs do not contradict international environmental agreements or human rights obligations). The overall objective is to ensure coherence between IIAs and sustainable development needs.
- In the *detailed design of provisions in investment agreements* between countries, policymakers need to incorporate sustainable development considerations, addressing concerns related to policy space (e.g. through reservations and exceptions), balanced rights and obligations of States and investors (e.g. through encouraging compliance with CSR standards), and effective investment promotion (e.g. through home-country measures).
- *International dialogue on key and emerging investment policy issues*, in turn, can help address some of the systemic challenges stemming from the multilayered and multifaceted nature of IIAs, including the gaps, overlaps and inconsistencies amongst these agreements, their multiple dispute resolution mechanisms, and their piecemeal and erratic expansion.

Addressing sustainable development challenges through the detailed design of provisions in investment agreements principally implies four areas of evolution in treaty-making practice:

- *Incorporating concrete commitments to promote and facilitate investment for sustainable development*. Options to improve the investment promotion aspect of treaties include concrete facilitation mechanisms (information sharing, investment promotion forums), outward investment promotion schemes (insurance and guarantees), and technical assistance and capacity-building initiatives targeted at sustainable investment, supported by appropriate institutional arrangements for long-term cooperation.

- *Balancing State commitments with investor obligations and promoting responsible investment*. For example, IIAs could include a requirement for investors to comply with investment-related national laws of the host State when making and operating an investment, and even at the post-operations stage, provided that such laws conform to the host country's international obligations. Such an investor obligation could be the basis for further stipulating in the IIA the consequences of an investor's failure to comply with domestic laws, such as the right of host States to make a counter claim in dispute settlement proceedings. In addition, IIAs could refer to commonly recognized international standards (e.g. the UN Guidelines on Business and Human Rights) and support the spread of CSR standards – which are becoming an ever more important feature of the investment policy landscape.
- *Ensuring an appropriate balance between protection commitments and regulatory space for development*. Countries can safeguard policy space by carefully crafting the structure of IIAs, and by clarifying the scope and meaning of particularly vague treaty provisions such as the fair and equitable treatment standard and expropriation, as well as by using specific flexibility mechanisms such as general or national security exceptions and reservations. The right balance between protecting foreign investment and maintaining policy space for domestic regulation should flow from each country's development strategy.
- *Shielding host countries from unjustified liabilities and high procedural costs*. The strength of IIAs in granting protection to foreign investors has become increasingly evident through the number of ISDS cases brought over the last decade, most of which have been directed at developing countries. Shielding countries from unjustified liabilities and excessive procedural costs through treaty design involves looking at options both in ISDS provisions and in the scope and application of substantive clauses.

These areas of evolution are also relevant for "pre-establishment IIAs", i.e. agreements that – in addition to protecting established investors – contain binding rules regarding the establishment of new investments. As a growing number of countries opt for the pre-establishment approach, it is crucial to ensure that any market opening through IIAs is in line with host countries' development strategies. Relevant provisions include selective liberalization, exceptions and reservations designed to protect a country from overcommitting, and flexibilities in the relevant treaty obligations.

Operationalizing sustainable development objectives in IIAs principally involves three mechanisms (table 5):

- Adjusting existing provisions to make them more sustainable-development-friendly through clauses that safeguard policy space and limit State liability.
- Adding new provisions or new, stronger paragraphs within provisions for sustainable development purposes to balance investor rights and responsibilities, promote responsible investment and strengthen home-country support.
- Introducing Special and Differential Treatment for the less developed party – with effect on both existing and new provisions – to calibrate the level of obligations to the country's level of development.

Table 6. Policy options to operationalize sustainable development objectives in IIAs

	Mechanisms	Examples
Adjusting existing/ common provisions to make them more sustainable-development-friendly through clauses that: • safeguard policy space • limit State liability	Hortatory language	- *Preamble*: stating that attracting responsible foreign investment that fosters sustainable development is one of the key objectives of the treaty.
	Clarifications	- *Expropriation*: specifying that non-discriminatory good faith regulations pursuing public policy objectives do not constitute indirect expropriation. - *Fair and equitable treatment* (FET): including an exhaustive list of State obligations.
	Qualifications/ limitations	- *Scope and definition*: requiring covered investments to fulfil specific characteristics, e.g., positive development impact on the host country.
	Reservations/ carve-outs	- *Country-specific reservations* to national treatment (NT), most-favoured-nation (MFN) or pre-establishment obligations, carving out policy measures (e.g. subsidies), policy areas (e.g. policies on minorities, indigenous communities) or sectors (e.g. social services).
	Exclusions from coverage/exceptions	- *Scope and definition*: excluding portfolio, short-term or speculative investments from treaty coverage. - *General exception* for domestic regulatory measures that aim to pursue legitimate public policy objectives.
	Omissions	- Omit FET, umbrella clause.
Adding new provisions or new, stronger paragraphs within provisions for sustainable development purposes to: • balance investor rights and responsibilities • promote responsible investment • strengthen home-country support	Investor obligations and responsibilities	- Requirement that investors comply with host-State laws at both the entry and the operations stage of an investment. - Encouragement to investors to comply with universal principles or to observe applicable CSR standards.
	Institutional set-up for sustainable development impact	- Institutional set-up under which State parties cooperate to e.g. review the functioning of the IIA or issue interpretations of IIA clauses. - Call for cooperation between the parties to promote observance of applicable CSR standards.
	Home-country measures to promote responsible investment	- Encouragement to offer incentives for sustainable-development-friendly outward investment; investor compliance with applicable CSR standards may be an additional condition. - Technical assistance provisions to facilitate the implementation of the IIA and to maximize its sustainable development impact, including through capacity-building on investment promotion and facilitation.
Introducing Special and Differential Treatment for the less developed party – with effect on both existing and new provisions – to: • calibrate the level of obligations to the country's level of development	Lower levels of obligations	- Pre-establishment commitments that cover fewer economic activities.
	Development-focused exceptions from obligations/ commitments	- Reservations, carving out sensitive development-related areas, issues or measures.
	Best-endeavour commitments	- FET, NT commitments that are not legally binding.
	Asymmetric implementation timetables	- Phase-in of obligations, including pre-establishment, NT, MFN, performance requirements, transfer of funds and transparency.

Source: UNCTAD, *World Investment Report 2012*. Detailed guidelines are also available in the online version of the IPFSD at www.unctad.org/DIAE/IPFSD.

The IPFSD and the way forward

UNCTAD's IPFSD comes at a time when the development community is looking for a new development paradigm, of which cross-border investment is an essential part; when most countries are reviewing and adjusting their regulatory frameworks for such investment; when regional groupings are intensifying their cooperation on investment; and when policymakers and experts are seeking ways and means to factor sustainable development and inclusive growth into national investment regulations and international negotiations.

The IPFSD may serve as a key point of reference for policymakers in formulating national investment policies and in negotiating or reviewing IIAs. It may also serve as a reference for policymakers in areas as diverse as trade, competition, industrial policy, environmental policy or any other field where investment plays an important role. The IPFSD can also serve as the basis for capacity-building on investment policy. And it may come to act as a point of convergence for international cooperation on investment issues.

To foster such cooperation, UNCTAD will continue to provide a platform for consultation and discussion with all investment stakeholders and the international development community, including policymakers, investors, business associations, labour unions, and relevant NGOs and interest groups.

For this purpose, a new interactive, open-source platform has been created, inviting the investment and development community to exchange views, suggestions and experiences related to the IPFSD for the inclusive and participative development of future investment policies.

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