Summary

The global recovery is fragile, because investment spending is insufficient to underpin continuing growth—

Strong cyclical dynamics, together with an easing of macroeconomic policies in the United States and elsewhere, have boosted large parts of the global economy into the initial phase of a recovery in 2002. The driving forces behind the initial phase of the recovery were strong, but they have proved short-lived because inventory and high-tech cycles are short and appear to have peaked. Though consumption spending has held firm, this is precisely the time when investment demand should pick up and boost recovery onto a higher trajectory. So far it has not. Financial imbalances, evident in different forms throughout the world economy, seem to be weighing down growth. Wide-ranging uncertainty in financial markets may jeopardize the needed rebound in fixed investment and may thus diminish prospects for projecting the global recovery into the future. Falling and volatile stock markets, accounting scandals, accumulated debts (domestic and foreign, private and public), and reassessments of long-run profitability keep investors cautious, if not jittery, throughout the world. For these reasons, growth in 2003 seems certain to be weaker for almost all developing regions than we anticipated as recently as six months ago.

Analysis of long-term trends indicates that the investment cycle as a determinant of overall cyclical behavior is as important in low- and middle-income countries as it is in high-income countries. But the volatility of investment is greater in developing countries than in rich countries. Countries with sound investment climates experience far less volatility than countries with deficient policies and institutions.

Capital flows to developing countries have proved to be procyclical. But the direction of causality between investment and capital inflow appears to differ significantly between rich and poor countries. In rich countries, a boom in domestic fixed investment tends to attract foreign capital, while in middle-income countries it is the acceleration of capital inflows that typically stimulates domestic investment. Similarly, a fall in rich countries' investment tends to reduce net capital inflows, while for middle-income countries reduced net capital inflows (or increased capital outflows) are the driving forces behind contractions in domestic investment. This dependence on capital flows makes the middle-income countries especially vulnerable to tensions in global financial markets. Low-income countries, with greater reliance on official aid and with limited access to private capital markets, do not exhibit either of these patterns.

—but long-term prospects remain promising

Over the long run, new opportunities for technological advances (often driven by globalization), together with more stable

macroeconomic policies and an improved business climate, have the potential to accelerate growth and to increase investment ratios in developing countries that currently lag behind. The outlook for reductions in global poverty, while generally positive and of the same order of magnitude as in our previous report, is marginally dimmer because of the absence of a robust recovery today.

At the same time, demographics are likely to alter existing savings and investment patterns and will tend to push countries to become more interdependent through capital flows. Major demographically driven shifts in current account balances—particularly in Japan, which is moving toward reduced surplus, and in middle-income countries, which are moving toward increased surplus—are likely to accelerate financial integration. Underneath large swings in net flows are even larger movements of gross capital flows, as foreign direct investment (FDI) expands into growing markets in developing countries and as financial agents in developing countries seek to diversify their portfolios in rich countries. However, because international financial flows have at times fluctuated widely, they have sometimes proved damaging to growth and poverty reduction. The international community and developing countries have to search for mechanisms to provide greater stability in integration. Developing countries can do much on their own. Improving the domestic investment climate, particularly through sound macroeconomic policies and governance, can reduce the volatility of capital flows and attract less-volatile FDI.

Global competition is creating new opportunities for developing countries

Cross-border trade and direct investment have expanded rapidly over the past three decades. Global exports of goods and services increased from 14 percent of output in the early 1970s to 23 percent by the late 1990s, while global FDI flows have more than doubled relative to the gross domestic product (GDP). The surge in FDI flows accelerated in the late 1990s, rising from $331 billion in 1995 to $1.3 trillion in 2000, before falling off to an estimated $725 billion in 2001. Most of these flows are destined to rich countries.

FDI flows to developing countries are about $160 billion. This amount is still relatively small compared with all domestic investment in developing countries, now about $1 trillion. Nonetheless, in virtually every region, FDI is a driving force of globalization and has risen relative to total capital expenditures during the 1990s. It has doubled in middle-income countries and has tripled in low-income countries. However, recently FDI flows have fallen. They peaked in 1999 at $184 billion and are experiencing their most sustained fall since the global recession of 1981–83.

These trends over the past decade have increased competition in most markets around the world. Despite a sharp increase in mergers and acquisitions, the share of global economic activity accounted for by the largest companies does not appear to have risen over the 1990s. The profits of the top 50 companies accounted for 0.8 percent of world GDP in 2001. Although their share of aggregate profits amounted to 3.3 percent of global savings in 2000, up from 1.8 percent in 1994, this increase is likely to be the result of the boom in the United States and the overstatement of earnings of some large U.S. corporations. These factors point to a pattern of stability rather than a trend of increases. Similar patterns exist for the largest 500 companies.

Four changes in the organization of business are particularly important for developing countries. First, the rise of foreign investment in services is creating a new source of competition—and potential productivity gains—in developing countries, where staid state companies have often monopolized production for decades. Recent efforts to privatize these companies and to open industries to competition have allowed some developing countries to harness this competition for gains. In many developing countries, restrictions on services still remain high, because some countries have

privatized only slowly and others have privatized badly, creating private monopolies still insulated from competition.

Second, production networks that span the globe, once barely a dot on the horizon of international business, have now become a central feature. That so many large firms have chosen to outsource production of parts and equipment or to otherwise locate production facilities offshore offers new opportunities for developing countries. Firms choosing to "deverticalize" production through outsourcing create new opportunities for suppliers and create a foundation for a steady increase in trade for participating developing countries. The downside is that this production and the associated high rates of export growth are highly concentrated geographically, and so this door into a greater share of the global economy has, to date, opened only for relatively few countries. Taking advantage of networks requires a strong policy environment that fosters private investment and provides complementary public investments (see below).

Third, with growing concerns about risk, investors are becoming increasingly sensitive to investment climates in developing countries, and the result is that money is moving to the countries with large, rapidly growing, and relatively stable economic environments. Countries such as China, the Republic of Korea, and Mexico benefited from the largest inflows in 2000. As a share of domestic investment, however, small-market countries are proving they can keep pace—provided that they protect property rights, have stable macroeconomic environments, and have good institutions. Poor countries that fall short on policies and institutions compound the disadvantages they already experience from having small markets. Hence, they may be virtually shut out from foreign investment flows in any sector other than natural resources.

Finally, long-term private investment financing for infrastructure has fallen off to levels that may prove persistent. This retrenchment has two origins. First, the post-1997 rise in global risk premiums has reduced investors' appetite for risk and for projects with long gestations. Adversity to such projects is reflected not only in the average spreads over U.S. Treasury interest rates that developing countries must pay to their bondholders in the Emerging Market Bond Index (even excluding country "outliers" in crisis) but also more generally in spreads of high-risk corporate bonds in the United States. Both have more than doubled from under 500 basis points to more than 1,000. The recent collapse of the telecommunications sector, as well as difficulties experienced by major power companies associated with the Enron scandal, has diminished the number of players and enthusiasm among potential long-term financiers. Second, many projects have suffered payment problems because of the inability of contracts to weather sharp contractions in demands. From Argentina to Indonesia, the string of defaults associated with infrastructure projects and restructurings has left in its wake a severe retrenchment. Thus, governments throughout the developing world will have to do more to offset this risk—principally through better policies, and perhaps through a slowing of the retreat from government financing of infrastructure that has occurred under the banner of privatization.

Harnessing globalization requires reducing barriers to competition—

To raise the productivity of both foreign and domestic investment, developing countries have to harness the full force of competition inherent in globalization. Too often they have not done so. In many countries, policy barriers to competition—whether they are impediments to trade, restrictions on incoming foreign investment, administrative barriers to competition, or monopolies granted to state enterprises—have channeled domestic as well as foreign investment into less-productive activities that dampen productivity improvement and hobble growth. Import competition, for example, can limit what would otherwise be the shared monopoly pricing of a few local

producers. In a wide sample of developing countries, decreasing imports in concentrated industries from 25 percent of domestic sales to zero is associated with increases of 8 percent in oligopolistic markups on sales.

Competition-impeding regulations in recently privatized industries have undermined potential benefits from privatization and have insulated new owners—frequently foreign companies—from efficiency-improving competition; the result has been slow growth and resource misallocation. In Africa, for example, telephone services in countries with private monopolies have expanded growth only one-third as fast as telephone services in countries with competitive networks.

Over time, firms in countries with lower barriers to trade and to investment competition tend, as a general rule, to enjoy significantly higher productivity of investment, both foreign and domestic, and with it more rapid growth. This fact does not imply a single prescription for all countries irrespective of their stage of development. As the experience of China—among others—has shown, reforms have to be tailored to country circumstances and integrated into sustainable development strategies. The analysis does imply, however, that countries wishing to increase their opportunities from globalization would do well to look first at the incentive features of their investment climate, with special attention to barriers that impede competition.

—and using targeted interventions with care—

Governments may hope to make up for an unfriendly investment environment through incentive mechanisms. But while there are clearly examples in which targeted interventions—such as fiscal incentives, export processing zones (EPZs), or support for economic clusters—may indeed lead to higher investment levels (and the jobs and related spillovers that go along with them), there is, unfortunately, little evidence that such initiatives can be systematically successful. Instead, they tend to work best when they work *in support of* broader reform packages, either to catalyze support for emerging opportunities (such as clusters) or to create transitional mechanisms and initial constituencies for reform that can be progressively expanded (such as EPZs). But more broadly, investment incentives will generally not make up for serious deficiencies in the investment environment or generate sustained growth. To encourage productive investment and benefit from globalization, governments must tackle the challenges of promoting competition and entrepreneurship and of undertaking complementarily productive public investment in areas such as education.

—and therefore sound public investments are essential

Public investment also plays a crucial role in enhancing growth. Some countries get both the levels and the composition of investment right, and their growth rates are high. Other countries invest too much through the public sector and crowd out private investment. Because these effects are also associated with investments in state enterprises that enjoy monopoly positions protected from competition, the composition effects of public investment are negative. Other countries invest too little through the public sector. This problem is usually manifested in poor education, poor infrastructure, and poor public institutions generally—all of which reduce profitable investment opportunities for both domestic and foreign companies. Investing in effective public institutions has an especially high return.

International agreements on investment and competition policies can provide benefits through reciprocity—

Countries get most of the positive growth stimulus from domestic unilateral reforms tailored to local strategy and conditions, and these reforms should not be held hostage to international agreements. Nonetheless, reforming governments may be able to obtain additional benefits from international agreements. Benefits can take several forms. For

investment policies, participating in international agreements that are linked to greater market access may elicit more investment by signaling to investors that changes are permanent. Also, participating in international negotiations may strengthen the hand of domestic reformers by holding out the prospect of market access abroad in exchange for new domestic policies; simultaneously, negotiations can prompt reciprocal reforms among partners that would not otherwise occur. For competition policy, international agreements may lead to the removal of restraints that inhibit competition, thereby unleashing new price competition that benefits all countries.

—but agreements on investment policy are likely to have strong development effects only if they deal with the big issues facing developing countries—

The purposes of coordinating investment policy are to expand the flow of investment around the world, to minimize policy externalities that hurt neighbors, and to help improve economic performance. Agreements might contribute to achieving these goals through three main channels: *protecting investors' rights,* which increases incentives to invest; *liberalizing investment flows,* which permits enhanced access and competition; and *curbing policies that may distort investment* flows and trade at the expense of neighbors.

International agreements that focus on establishing protections for investors cannot be expected to expand markedly the flow of investment to new signatory countries. This is because many protections are already contained in bilateral investment treaties (BITs). Even the relatively strong protections in BITs do not seem to have increased flows of investment to signatory developing countries. These facts suggest that expectations for new flows associated with protections emerging from any multilateral agreement should be kept low.

International agreements that allow countries to negotiate reciprocal market liberalization and to promote nondiscrimination can reinforce sound domestic policies and can contribute to better performance. Since most of the remaining restrictions are on services, governments around the world can increase market access by using the existing multilateral framework rather than creating a new one. The General Agreement on Trade in Services (GATS) provides an as-yet-underutilized arrangement to negotiate reciprocal market access in services. To date, the coverage of commitments for a large number of countries is limited. About two-thirds of the World Trade Organization membership has scheduled 60 or fewer sectors (of the 160 or so specified in the GATS list). Moreover, in many cases, commitments do not reflect the actual degree of openness. Finally, in some countries, the commitments that have been made serve only to protect the privileged position of incumbents rather than enhance the contestability of markets. To remedy these problems, governments must take greater advantage of the opportunity offered by the GATS to lend credibility to reform programs by committing to maintain current levels of openness or by precommitting to greater levels of future openness. To advance the process of services reforms beyond levels undertaken independently and to lead to more balanced outcomes from the developing-country point of view, countries could better harness the power of reciprocity by devising negotiating formulas that widen the scope for tradeoffs across sectors (both in goods and in services) and across modes of delivery, particularly the temporary movement of workers. While difficult, such efforts may prove easier than designing a whole new international investment arrangement.

Similarly, curbing policy externalities that "beggar thy neighbor" can benefit developing countries, especially if the countries focus on two critical issues. The first is to reduce *investment-distorting trade barriers*. By depriving developing countries of market access and by discouraging their exports, many trade barriers also lessen the attractiveness of opportunities to invest in developing countries' export industries for both foreign and domestic

investors. In Canada, the European Union (EU), Japan, and the United States, average ad valorem–equivalent tariffs for manufactures are roughly twice as high for developing countries as they are for members of the Organisation for Economic Co-operation and Development. The ad valorem–equivalent tariffs on agriculture (to say nothing of subsidies) in those countries are also more than three times higher than such tariffs on manufactures. Reducing trade barriers among developing countries themselves is as important as reducing trade barriers in rich countries. Developing countries import from each other at average ad valorem–equivalent rates comparable to EU rates for imports from developing countries. This level of protection dampens investment—both domestic and foreign—in affected export industries, and removal of these barriers would have significant development effects.

The second critical issue is to curb the emerging competition among countries to lure foreign investment through *investment incentives*. Unfortunately, information on the extent of investment incentives is inadequate to assess their effects, and so a high priority for international collaboration is to systematically compile this information.

Finally, participation in international agreements on investment may also have benefits over and above unilateral reforms if the agreements include reciprocal market access in areas of importance to developing countries. These benefits can become clear only in the course of negotiation.

—and thus competition agreements should focus on restraints to competition that hurt developing countries

Greater competition is associated with more rapid development, and lowering policy barriers to trade and foreign investment in developing countries, as shown in chapter 3, is a powerful procompetitive force. Beyond unilateral actions, international agreements on competition policy might also bring benefits, provided they address the major restrictions that adversely affect developing countries.

Restrictions on competition in the global marketplace that most hurt development take three forms. The first form consists of *policy barriers in markets abroad* that limit competition among developing countries in these markets. These barriers, like those discussed above, discourage investment and create obstacles to competition. Particularly harmful are the $311 billion in agricultural subsidies and textile quotas, as well as the corresponding high border protection, tariff distortions (that is, tariff peaks and escalation), and protectionist use of antidumping. These practices are only too common in all countries, rich and poor alike. All of these trade restrictions limit the ability of exporters in developing countries to compete in international markets.

Second, *private restraints on competition* can adversely affect prices for consumers and producers in developing countries—much as they can in industrial countries. For example, cartel practices among companies based in high-income countries taxed consumers in developing countries by up to $7 billion in the 1990s. Actions that facilitate prosecution of cartels should be high on the priority list. Such actions can range from developing more systematic arrangements to exchange information among competition agencies, to granting standing for developing countries to sue under foreign antitrust laws when their trade is adversely affected. Indeed, both developing and industrial countries would benefit from much greater efforts to identify and document restrictive business practices that adversely affect prices of their trade.

Third, many governments in high-income countries *officially sanction trade restraints* through antitrust exemptions for their companies in domestic law. For example, many governments permit their companies to cartelize exports. Shrouded in the secrecy of government registries, these national export cartels may well raise prices to developing countries. Efforts should be made to make information on national export cartels transparent. Everyone would benefit from a decrease in cartels that have damaging price effects. Similarly, antitrust

exemptions for ocean transport have given rise to price-fixing arrangements that systematically hurt consumers everywhere, including those in developing countries. These restraints are estimated to cost developing countries more than $2 billion per year and entail similar costs to consumers in industrial economies.

Finally, competition policies in developing countries themselves can in many cases be improved through increased transparency, nondiscrimination, and procedural fairness. However, international cooperation in this complex area of regulation has to recognize that countries have different capacities and institutional settings, warranting caution in recommending—much less in mandating—across-the-board policies. In this area, voluntary programs that facilitate the learning and adoption of best practices in developing countries can pay high dividends.

Unlocking global opportunities begins with the efforts of developing countries to improve their investment climates. Deployed well, investment policies and policies to unleash competition can accelerate economic growth and reduce poverty. This report offers a general framework and lessons, but each country has to formulate its own development strategy. Nonetheless, the international community, working together, can help through development assistance, voluntary collaboration, and well-conceived international agreements. For these efforts to have greatest effect, they have to tackle the most pressing investment and competition problems—and that is the challenge ahead.