

# Improving the investment climate in APEC economies

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The World Bank has identified investment as the key driver of growth and poverty reduction. An investment climate with few barriers is most likely to ensure investment is plentiful and used efficiently. In APEC economies, domestic investment makes up nearly three-quarters of all investment and therefore has the greatest potential to lift growth. Many studies have measured barriers to foreign direct investment at the border but surprisingly few have measured barriers 'behind-the-border' to domestic investment. We need to understand much more about behind-the-border barriers to investment in APEC and their impact to be able to assist APEC developing member economies make better informed policy choices when removing barriers to investment. Recent APEC experience with investment climate reform is briefly examined for any thematic lessons and whether there could be a better way to undertake such reform in the future. Specific work under way in APEC is discussed in the final section.

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## Introduction<sup>2</sup>

Michael Porter, the Bishop William Lawrence University Professor, based at Harvard Business School, has stated:

Almost everything matters for competitiveness. The schools matter, the roads matter, the financial markets matter and customer sophistication matters. True competitiveness, then, is measured by productivity. Productivity allows a nation to support high wages, attractive returns to capital, a strong currency – and with them, a high standard of living. What matters most are not exports per se or whether firms are domestic or foreign-owned, but the nature and productivity of the business activities taking place in a particular country.

There is now almost universal agreement that a strong correlation exists between the investment climate and growth and poverty reduction. The World Bank defines the investment climate as ‘the location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand’ (World Bank 2005b). Another way of looking at the ‘location-specific factors’ referred to by the World Bank is as barriers presented by government policies and behaviours that exercise decisive influence over such things as security of property rights, regulation and taxation, provision of infrastructure, the functioning of financial and labour markets and the rules determining corporate and public governance.

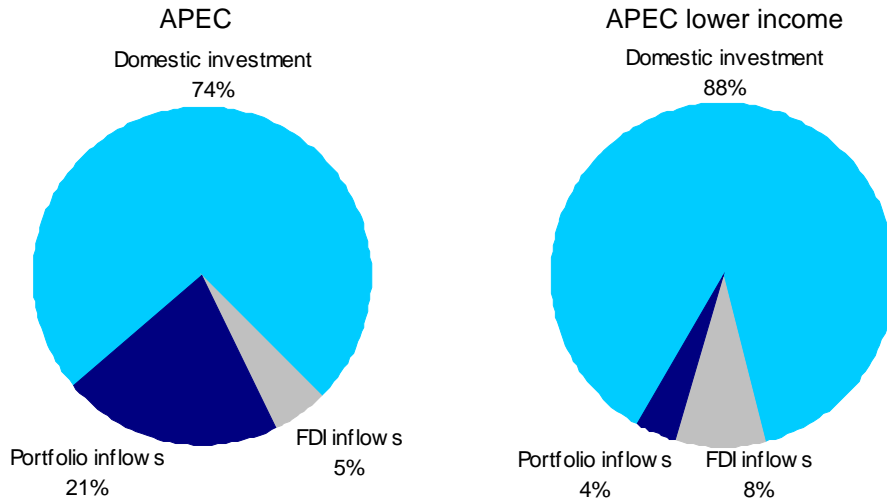
## Investment in APEC

Foreign savings – which can be either foreign direct investment (FDI) or foreign portfolio investment – or domestic savings, finance investment. The vast majority of APEC investment is domestic investment, particularly in lower income APEC economies where domestic investment comprised 88 per cent of gross fixed capital formation over the period 2002 to 2004 (Chart 1). Lower income APEC economies tend to receive more FDI than foreign portfolio investment which is hardly surprising given the lower level of sophistication of their financial markets relative to more developed APEC economies.

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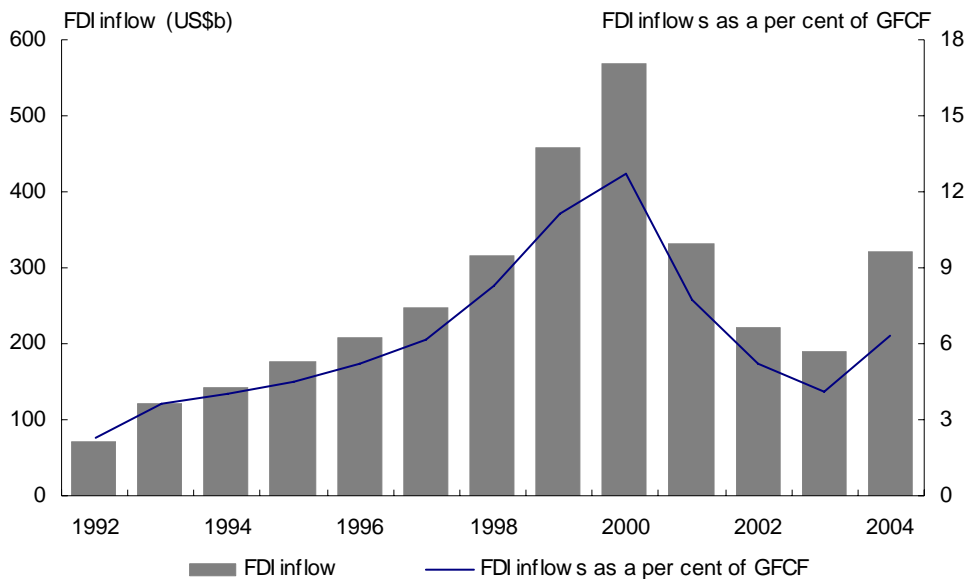
2 This section draws extensively on a study commissioned by APEC by the Centre for International Economics (see APEC/CIE 2006).

**Chart 1: Composition of investment in APEC**  
(average 2002 to 2004)



Note: APEC lower income economies are those classified as low income or lower-middle income by the World Bank (China, Indonesia, Papua New Guinea, Peru, Philippines, Thailand and Vietnam).  
Source: APEC/CIE 2006, p 14.

**Chart 2: FDI inflows into APEC economies**



Note: FDI inflows into APEC economies were not uniform across the APEC region.  
Source: APEC/CIE 2006, p 15 based on UNCTAD data.

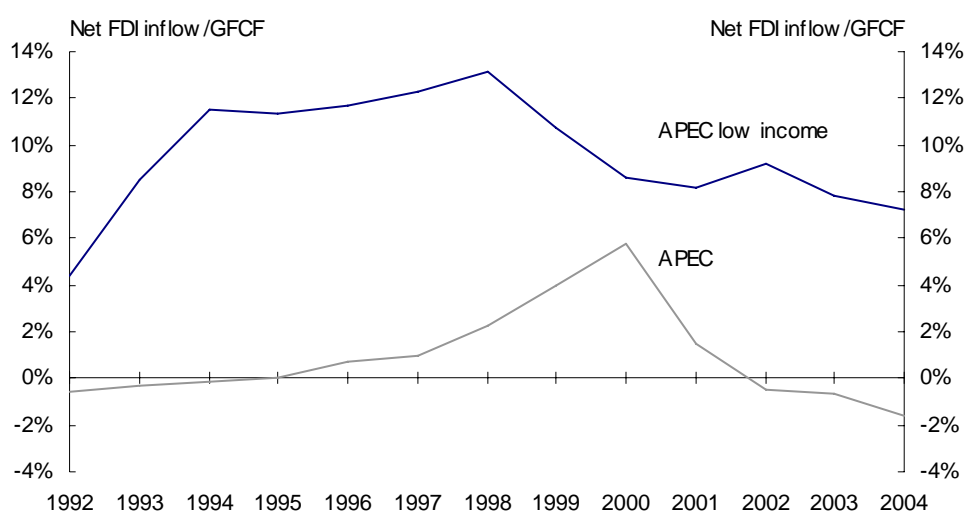
The significance of FDI inflows as a source of financing for both APEC and the rest of the world rose during the 1990s before tumbling from 2001 to about 4.5 per cent of GFCF in 2003 (Chart 2). FDI inflows have started to rise again and reached about

## Improving the investment climate in APEC economies

6 per cent of GFCF in 2004. For lower income APEC economies, preliminary UNCTAD figures show a significant rise in FDI inflows in 2005 from about \$US67 billion in 2004 to \$US87 billion.

More FDI is now flowing out of the region than into it (Chart 3). Within APEC, FDI flows typically move from developed economies to developing economies which is what economic theory would suggest, with lower income economies potentially having many more profitable investment opportunities and a higher expected marginal product of capital.

**Chart 3: FDI inflows less FDI outflows for APEC member economies**



Source: APEC/CIE 2006, p 18 based on UNCTAD data.

APEC lower income economies save about 10 per cent more than they invest, with the excess flowing abroad. Indications of this trend are the large current account surpluses that exist in most lower income APEC economies (several are in the 5-10 per cent range) matched by large current account deficits in APEC developed economies: Australia, United States and New Zealand all recorded deficits in excess of 5 per cent of GDP in 2004. The paradox of APEC lower income economies effectively financing the current account deficits of certain APEC developed economies through their surpluses suggests that it is not the lack of domestic savings that is constraining investment.

## Barriers to investment in APEC economies

### FDI barriers

There has been plenty written about barriers to FDI including suggested ways in which to quantify the various restrictions that prevail. (See Productivity Commission 2001, OECD 2003, UNCTAD 2005b and APEC/CIE 2006.) The methodology used in these studies has been criticised for a number of conceptual and practical impediments and there is room for further work and improvement. Despite these problems with the methodology, the unmistakable key message coming through this work is that APEC economies have substantial barriers to FDI albeit with considerable variation in the level of restrictiveness.<sup>3</sup> These barriers are in the form of limits on equity and control of businesses in particular sectors; prior screening or licensing regimes; and an array of operational restrictions that affect the movement of labour, level of domestic content and board membership and senior management. A study of impediments to FDI in the financial sector conducted by the APEC Business Advisory Council (ABAC 2004) which was based on surveying APEC businesses, amply demonstrates the range of restrictions foreign investors face in many APEC economies.

There is significant convergence of informed opinion about the potential benefits of lowering FDI barriers in APEC economies. First there would be both stimulus to intra-APEC FDI flows and encouragement for FDI from outside the region to enter. Second there would be a productivity benefit based on FDI bringing important skills and technology. Third, there could also be a flow-on effect encouraging more domestic investment throughout the region.

The magnitude of these benefits depends on the degree of liberalisation in each particular economy. An approach often adopted in measuring the impact of lowering FDI barriers is to employ a scenario under which the reduction in FDI barriers in each economy is to the level of the most open economy. The APEC/CIE study, using previous estimates based on partial indicators<sup>4</sup>, found that under such a scenario:

- FDI levels across APEC would increase by about 20 to 30 per cent (Nicolletti et al, 2003);

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3 The scale of barriers is from 0 to 1 with 0 being fully open. The APEC average according to APEC/CIE is 0.36 and the range for those economies measured is from below 0.2 to a little under 0.7 – readers interested in examining this in more detail should look at Chart 3.2 in APEC/CIE (2006).

4 The APEC/CIE study notes that calculating the potential impact of lowering FDI barriers would ideally capture the linkages between different types of investment, rates of return and economic activity. As no such framework has been developed, only partial indicators linking barriers, investment and growth are available.

### Improving the investment climate in APEC economies

- a 1 per cent increase in FDI could increase productivity of domestic firms and GDP by up to 1.6 per cent (see Klein, Aaron and Hadjimichael 2001 for a summary of estimates);
- GDP would be boosted by 2 to 3 per cent in APEC economies (or about \$600 billion in the APEC region) even taking an estimate of productivity growth at the low end of the zero to 1.6 per cent range, such as 0.1 per cent;
- lower income economies would likely experience a greater increase in FDI as their barriers are currently relatively high, indicating more compelling reasons for them lowering FDI barriers; and
- the impact of growth on poverty could reduce the number of people living on less than \$1 per day by about 20 per cent (Adams 2003, using World Bank estimates).

### Understanding the impact of behind-the-border barriers

Lowering FDI barriers in APEC economies can bring substantial economic and social gains. But behind-the-border barriers are key to improving outcomes in APEC. Behind-the-border barriers are policy or institutional shortcomings that impede investment and thereby stop an economy from achieving optimal growth and productivity. These policy failings and institutional inadequacies include issues relating to legal certainty in the economy, poor public and corporate governance, inadequate competition, too much and overly complex regulation in product and labour markets, poor infrastructure development (including access to finance), uncertainty and lack of transparency in administration.

While the importance of behind-the-border barriers is becoming well known in APEC, quantifying the impacts has not been done. Outside APEC, there have been attempts to quantify behind-the-border barriers at a macroeconomic level including their incidence, prevalence, impact on the cost of doing business and effect on risk and complexity. It is possible to speculate that behind-the-border barriers will have a more negative impact on domestic investment including returns, level of risk and the creation of economic rents for particular investors. Case studies of the success stories in certain economies have advanced what we know about the impact of easing behind-the-border barriers but there are still many gaps in our knowledge which warrant further study. Not well understood are the relationships *between* different behind-the border barriers.

We need to generate the same level of debate about the impact of removing behind-the-border barriers as has been generated by the attempts to measure the impact of removing barriers to FDI. As the APEC/CIE study recently concluded:

Two things are required to capture the benefits of removing behind-the-border barriers. Firstly, a formal way of assessing the impacts of these impediments would improve knowledge and increase transparency. Secondly, a process by which the assessment and quantification of barriers in an economy wide framework can occur is also required. This process would generate wide public debate and would aid the removal of these impediments.

## The importance of investment climate reform

The World Bank Group and others have put a significant amount of analytical effort into understanding the investment climate and the importance of reform. There has been an increase in the number of institutions producing measures of the impact of government policies on:

- the costs of doing business;
- risk through policy uncertainty, lack of transparency and macroeconomic instability; and
- the regulation of market entry and exit and anti-competitive behaviour.

The World Bank leads the way with its Investment Climate surveys, Doing Business project, Governance Indicators and World Development Indicators. Other institutions that have produced general measures of competitiveness, risk or lack of freedom to invest include the World Economic Forum, Transparency International, Heritage Foundation, Fraser Institute, International Institute for Management Development and the Economist Intelligence Unit.

## Determining investment reform priorities: some case studies

The hopeless quest to identify a consensus where there is none should be abandoned in favour of a debate on the policy changes needed to achieve a rounded set of objectives encompassing at least the level, growth, and distribution of income, as well as preservation of a decent environment. (Williamson 2000)<sup>5</sup>

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5 John Williamson was credited with inventing the term 'Washington Consensus' which he claimed originally meant the lowest common denominator of policy advice addressed by the Washington-based institutions (including the World Bank) to Latin American countries as of 1989. However, he noted that the subsequent use of the term came to signify neo-liberal or market fundamentalist policies.

The World Bank seems to have heeded Williamson's advice. In advising on how to determine priorities for investment climate reform, World Bank methodology has become more context-specific, sectoral and more targeted. For example, the World Bank's Investment Climate surveys are based on detailed questioning of investors that helps identify some of the most important issues. There are recent examples of the World Bank using value chain analysis to develop targeted action programmes in particular sectors. The World Bank Group's Doing Business indicators benchmark and rank the cost and quality of business regulations for key crosscutting investment climate issues. Finally, as Michael Klein, Vice President of Private Sector Development at the World Bank/International Finance Corporation recently wrote, 'As with change management in firms, the best we may be able to do is to generate interesting case studies that help sharpen judgment and inform policymakers about the process and impact of reforms.' (See World Bank/IFC 2006, p ix.)

The World Bank's investment climate reform work in Indonesia and the Philippines (see Box 1) offers some interesting insights into the process of reform in these two APEC economies. Previous reform efforts tended to be concentrated around periods of political change and/or financial or economic crisis. More recently the case for getting investment reform onto the agenda was built around the case study information coming out of the World Bank, together with several years of hard benchmark data from various surveys and the Doing Business project which showed Indonesia and the Philippines were slipping in the rankings. In both cases the judgment was that swift action was required. Second, reform momentum dissipates fairly quickly if there is not the institutional structure in place to implement and coordinate the reform process<sup>6</sup> effectively – this suggests that various domestic institutions play a vital role in nurturing ongoing support for reform and its implementation.

Third, in the early stages of reform there is a need for a certain amount of public education and persuasion to generate 'buy-in' for reform. In that regard, the Philippines seems to have opted for a narrower and more structured dialogue with the private sector and other stakeholder groups on its multi-faceted action agenda on competitiveness. Such consultation is clearly necessary as the role of the private sector in implementation is important and in any event can elicit new ideas. Finally, previous reform initiatives, even if they are well designed, can be ineffective or undone by poor implementation and monitoring.

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6 Interestingly, in the first half of 2006, Indonesia introduced three new policy reform packages designed to accelerate economic growth – Policy Package for Improving the Investment Climate, Policy Package for the Acceleration of Infrastructure Development and Financial Policy Sector Package.



### **Box 1: Investment climate reform in Indonesia and the Philippines**

The Asian Development Bank and World Bank commenced a major study of the Indonesian investment climate in the second half of 2003 with a survey covering 713 manufacturing establishments. A major report, *Improving the Investment Climate in Indonesia*, was published in May 2005. At the firm level, the ADB/WB Investment Climate Survey found some matters required serious attention with the most severe business obstacles identified being macroeconomic instability, economic and regulatory policy uncertainty and corruption. Other problems included poor or difficult access to finance, poor electricity supply, labour regulations (more so than skills), and severe problems at the sub-national level of government heightened by recent decentralisation. Similar problems featured in the comparison between Indonesia and other economies. The World Bank *Doing Business* reports provided benchmarked data which clearly showed some of these issues were actually getting worse and Indonesia's relative performance in the region was deteriorating.

In late 2005, the Indonesian Government seemingly accepted that much more needed to be done (Ikhsan 2005) in the areas of fiscal reform, trade liberalisation, financial sector reform, tax, labour and business regulation and lowering jurisdictional risk. There was clear recognition of the need to improve coordination of reform initiatives and to focus more on a microeconomic reform agenda. Indonesia's self-assessment concluded that there were gaps between political will and implementation on the one hand and a need for more hands-on policy to improve the investment climate at the central and regional levels of government on the other hand.

The Philippines features have much in common with those described for Indonesia. Again, the World Bank and the ADB conducted an Investment Climate Survey in 2003 and the World Bank produced a detailed assessment report in 2005 (see World Bank 2005c). This report noted that the Philippines had enormous growth potential and while it had instituted a number of reforms in the 1980s and 1990s these had produced only modest growth. The main reasons behind this lower than expected growth were poor fiscal conditions and low institutional quality. High uncertainty about future macroeconomic stability raised borrowing costs for the private sector, thus increasing resources were swallowed up to meet debt servicing requirements (as high as 37 per cent of revenues by 2004). This both crowded out private sector activity and delayed crucial public investment in infrastructure and institutional development. Business surveys confirmed the high costs to business of unreliable infrastructure, contract enforcement, crime and security, bribes and regulatory compliance which could represent as much as 26 per cent of revenues. The Philippines ranking also slipped in nearly every independent benchmark indicator related to competitiveness, ease of doing business, corruption and human development.

### **Box 1: Investment climate reform in Indonesia and the Philippines (continued)**

In 2006, the Philippines began to take notice of its apparently inexorable slide down the world competitiveness rankings and convened a National Competitiveness Summit in October 2006. The Summit was intended to highlight commitments derived from both the private and public sectors to improve the country's competitiveness. The initial objective was to develop an Action Agenda for Competitiveness which will contain the short- and medium-term action points that both private and public sector institutions must execute. As a working target, the aim is to lift the Philippines' competitiveness ranking in a number of benchmarking publications from the bottom third to the top third by 2010. The Action Agenda developed at the Summit agreed to focus initially on sources of competitiveness, namely: competitive human resources; efficient public and private sector management; effective access to financing; improved transaction flows and costs; seamless infrastructure network; and energy cost-competitiveness and self-sufficiency.

## **What is APEC doing to promote investment climate reform?**

In seeking to meet this challenge of improving the investment climate in APEC member economies, the APEC Investment Experts Group (IEG) has recognised the need to do more work in a number of important areas:

- the need to go further with its existing work on barriers to domestic and foreign investment, both at-the-border and behind-the-border, and to identify clearly what is at stake if economies maintain high barriers;
- assisting developing member economies in making more optimal policy choices when considering the process of reform of their domestic investment climates; and
- listening to the views of business about the investment climate and building and maintaining effective public-private dialogues.

### **Behind-the-border barriers**

A second stage of the APEC/CIE study on investment barriers has been approved for funding by APEC. As a first step, we need to build a picture of behind-the-border barriers in each APEC economy by pulling together existing information into a coherent framework. The World Bank's annual Doing Business survey, the core study for this exercise, lists among these barriers: weak property rights, corruption, poor regulation and lack of competition policy. There are many linkages between these. In

looking at such information, it would be useful to consider the cost, the barriers and the linkages between different behind-the-border barriers.

IEG's initial aim is to report behind-the-border barriers to investment as a series of indicators – an information set from which users can draw conclusions. The next step will be to gather and analyse success stories of APEC members (for example, from China, Indonesia, the Philippines, Viet Nam and Australia) as a means of reinforcing the importance of removing these barriers. The final step will be to produce a stocktake of what institutional mechanisms are available in each APEC member economy that can create and nurture support for reform of the policies that operate as behind-the-border barriers. Analysis of the capacity of such institutions to undertake reform might be expected to increase the demand for institutions to be established and maintained.

IEG is by no means the only APEC forum working on structural reform (for example, the Economic Committee together with certain competition-related working groups is pursuing a broad structural reform agenda) but this stage 2 study could be useful in facilitating discussions in/with other APEC forums concerning the relative importance of particular behind-the-border barriers, their impacts, and potential reform paths for collaborative action by APEC economies.

### Guiding policy choices when undertaking investment reform

The World Bank experience with investment climate reforms indicates that there is no standard process or one-size-fits-all approach. Measurement or benchmarking helps to diagnose constraints and identify the reform priorities and build momentum for reform. Best practice approaches to reducing business costs from regulation, reducing risk from policy uncertainty and increasing competition are helpful guides from which developing economies can learn. We should also welcome new approaches and be prepared to use pilots and sector-specific interventions as learning and demonstration tools when reforms face great uncertainty or strong opposition.

Issues for policymakers to consider include: a need for more analysis of the complementarities across reform areas (to help inform packaging and sequencing reforms, especially in countries with low institutional capacity); which reforms can be bundled and which should not be; which reforms need support by action in other areas; and with limited reform capacity, which measures will deliver an early harvest in terms of policy credibility and certainty?

One approach which APEC Ministers believe is worthy of further study and collaboration is the OECD Policy Framework for Investment (PFI) – see Box 2.

The PFI is a new concept for approaching investment policy. Compared with more traditional instruments which are based on a foreign investment/domestic investors divide, the general aim of the PFI is to improve the general business environment and create a genuine level playing field for all investors. The PFI integrates all the relevant regulatory variables that are essential to the establishment of a friendly investment policy environment with a view to achieving global consistency and enhancing possible synergies between various policy initiatives. It supports the efforts of governments to encourage sustainable economic growth built on private investment.

### **Box 2: The Policy Framework for Investment**

The Policy Framework for Investment (PFI) is a component of the OECD Initiative on Investment for Development and was launched in Johannesburg in November 2003. The objective of the PFI is to mobilise private investment that supports economic growth and sustainable development. Thus it aims to contribute to the prosperity of countries and their citizens as well as to support the fight against poverty. The PFI proposes a set of questions for governments to consider in ten policy fields identified in the 2002 UN Monterrey Consensus on Financing for Development as critically important for improving the quality of a country's environment for investment. The PFI was completed in April 2006 and endorsed by OECD Ministers on May 24 2006. The PFI has been developed as a partnership process. It has involved about 60 economies (30 OECD and 28 non-OECD) including 15 APEC economies.

The PFI is a tool that economies can adapt in order to benchmark their policies for investment against broadly accepted international practices. It highlights ten domains that, beyond stable macroeconomic conditions, have a strong bearing on the investment climate. These are: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; responsible business conduct; human resource development; infrastructure development and financial services; and public governance.

Each of the policy areas considered under the PFI comes with a series of probing questions to test for quality and coherence, based on non-OECD (and OECD) experiences, as well as the established principles embodied in international agreements. To take just a few examples, questions in the investment policy chapter relate to the broader benefits for domestic and foreign investors alike of regulatory transparency, property rights protection and fair treatment for all investors. The PFI asks whether trade policies that restrict imports act as an obstacle to investment in both the host and home countries by increasing the cost of doing business and by shrinking the size of markets. In the field of competition policy, it tests whether the principles in operation are used in support of the broader investment strategy.

More information: OECD (2006a) and OECD (2006b).

The PFI also gives a greater weight to self-examination and policy dialogue as compared to more traditional peer pressure mechanisms. It recognises that host economies should identify their achievements and shortcomings and that they should test possible solutions to existing problems. The PFI is not prescriptive and has ample room to accommodate individual country situations, cultural traditions and local constraints. But the PFI also embodies a wealth of experience accumulated over the years and offers examples of best practices and solutions to problems that have proven to be effective in many countries. It therefore provides a useful reference point for conducting investment policy reforms.

As a next step IEG is planning to organise a high-level public-private dialogue on the PFI in Melbourne in March 2007 to exchange views between, inter alia, high-level policymakers, international organisations, donor banks and business people on how this new tool could help to improve the investment climate in the APEC region. Central to the discussion in Melbourne will be a dialogue on how individual economy PFI assessments will be undertaken, based on some initial methodologies developed with respect to a number of APEC developing member economies. There will also be some exploration of the potential for the PFI as a tool for regional 'peer learning' and 'peer dialogue'.

### Dialogue with the APEC business community

Enhanced dialogue and close collaboration with the business community are essential to improving the environment for investment. Mutual participation of the IEG Convenor and ABAC representatives in their respective meetings has greatly enhanced interaction between IEG and ABAC in the past two years. For example, the IEG has considered carefully the 'Barriers and Impediments to Foreign Direct Investment (FDI): Checklist and other Sectors and Recommended Policy Response' developed by ABAC as an important input from business communities. As a next step, the IEG will conduct a comprehensive survey to identify high-priority investment barriers, building on various surveys including those of the World Bank, the World Economic Forum and the International Institute for Management Development (IMD) and organise a symposium back-to-back with the second ABAC meeting to be held in Tokyo in 2007. The survey will seek to identify the priority policy issues with the participation of the business community. Another issue for study is the scope for public-private dialogues and their involvement in improving the investment climates in specific APEC economies, including an assessment of existing dialogues in APEC economies.

## Conclusion

This article has sought to demonstrate that an improved investment climate is crucial to sustainable development. Broadly speaking, APEC economies have significant barriers to FDI although the level of restrictiveness varies considerably. Behind-the-border barriers constitute the greatest impediment to that growth but quantification of their impacts and of the interplay between barriers is not well understood. Improved understanding will allow APEC economies to determine reform priorities that are most likely to enhance the investment climate. APEC's Investment Experts Group is striving to meet this challenge through quantitative research, assessment of international best practice policy frameworks and a more complete exchange of ideas with business.

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