Foreign Direct Investment in Developing Countries:
What Economists (Don't) Know and What Policymakers Should (Not) Do!

Monographs on Investment and Competition Policy, #11

कट्स CUTS
Twenty Years of Social Change
1984 to 2003

0216

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Published by:

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Printed by:
Jaipur Printers P. Ltd.
Jaipur 302 001

ISBN 81-87222-70-0

#0216 SUGGESTED CONTRIBUTION Rs.30/$5

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Preface

Among the different forms of capital flows, academics and policymakers, talk about foreign direct investment (FDI) the most. This is because of several benefits of FDI and its importance in the world economy vis-à-vis other forms of capital flows. In the past fifteen years, FDI has been the dominant form of capital flow in the global economy, even for developing countries.

In the mid-1990s FDI flows, for the first time, became greater than that of official development assistance (ODA). At the same time, the world economy witnessed a number of economic crises in Latin America and South East Asia.

Foreign investors were blamed for these crises and analysts began to wonder whether it is a good idea for economies-especially the emerging ones- to depend on external capital for growth and development. People, who oppose the opening up of economies to foreign investors condemn FDI as risky and destabilising for developing economies.

At the other end of the spectrum, supporters vouching for FDI say that it is stable and is a source of advanced technology and better managerial practices. So it is good for developing economies.

The reality, however, is that it is not easy to draw any conclusions. A number of factors come into play to determine the growth and development effects of FDI. Therefore, it is important to be dispassionate while discussing the role of FDI in developing economies. Further research and information dissemination can rectify some of the misconceptions regarding FDI. It is important for economists to have clear notions about FDI because they are the ones who influence the policymakers.

Policymakers have the most important role to play. They should be aware of the various measures to induce FDI and the factors that determine their flows. Often policymakers rush into FDI liberalisation policies without considering the pros and cons of the policies and without any definite strategies. The experience of the South East Asian economies with FDI tells us that it can be extremely useful for emerging economies if it is used strategically.

FDI, however, does not depend solely on domestic determinants. There are several external factors influencing FDI flows, which are beyond the control of an individual developing country. Thus, policymakers should not expect too much from the measures designed to encourage FDI or from FDI itself. FDI can be seen as a complement to domestic investment.

While discussing FDI all these aspects should be considered. We, at CUTS, have attempted to highlight various aspects of the debate on FDI through a series of monographs on investment and competition policy. This is another one in the series.

The monograph discusses the global FDI trends and determinants, and attempts to highlight some of the arguments on the link between FDI and growth. We are extremely grateful to Peter Nunnenkamp of Kiel Institute of World Economics, Gemany for allowing us to publish this.

Jaipur, India
August 2002

Pradeep S. Mehta
Secretary General

I
Introduction

Especially since the recent financial crises in Asia and Latin America, developing and newly industrialising countries have been strongly advised to rely primarily on foreign direct investment (FDI), in order to supplement national savings by capital inflows and promote economic development.

Even harsh critics of rash and comprehensive capital account liberalisation dismiss the option of complete isolation from international capital markets and argue in favour of opening up towards FDI (e.g. Stiglitz 2000).

FDI is considered less prone to crisis because direct investors, typically, have a longer-term perspective when engaging in a host country. In addition to the risk-sharing properties of FDI, it is widely believed that FDI provides a stronger stimulus to economic growth in host countries than other types of capital inflows. The underlying argument is that FDI is more than just capital, as it offers access to internationally available technologies and management know-how (*The Economist* 2001).[1]

Yet, economists know surprisingly little about the driving forces and the economic effects of FDI. There are few undisputed insights on which policy-makers could definitely rely. The relevance of earlier findings on the determinants of FDI is debatable. The relative importance of traditional determinants may have declined in the process of economic globalisation. The economic effects of FDI do not allow for easy generalisations. Empirical studies on the growth impact of FDI have come up with conflicting results.

The subsequent stock-taking starts by portraying the recent trends with regard to the growth and distribution of FDI (Section II). The discussion of FDI determinants in developing and newly industrialising countries focuses on factors that can be influenced by host country governments (Section III). Section IV provides an overview of recent studies on the economic growth effects of FDI in developing and newly industrialising countries. Section V summarises and offers some policy conclusions.

1. *The Economist* (2001). The Cutting Edge. February 24: 90 and Borensztein et al. (1998) as well as UNCTAD (a, 1999: 207) consider FDI to be a major channel for the access to advanced technologies by developing countries.

II
FDI Trends: Winners and Losers

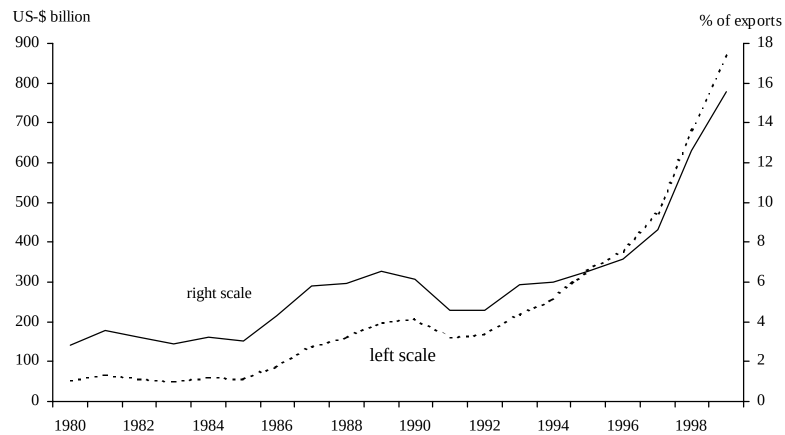
The recent boom in world-wide FDI flows constitutes a major element of economic globalisation. Annual FDI flows increased fifteen-fold from US $55bn in 1980 to US $865bn in 1999 (Figure 1). FDI soared not only in absolute terms but also in relative terms.

Overall FDI flows accounted for about 3 percent of world-wide exports in 1980-1985. In 1999, the FDI/export ratio exceeded 15 percent (Figure 1). In other words, while exports remain the dominant form of corporate internationalisation strategies, globalisation through FDI has gained significantly in relative importance.

The much-heralded FDI boom has to be qualified in several respects, however. Over much of the period under consideration, FDI increased only moderately, relative to exports. The significant rise in this ratio is largely restricted to recent years (i.e. 1992-1999). As a consequence, the growth in FDI is far less pronounced when world-wide FDI stocks are related to world GDP (Figure 2).

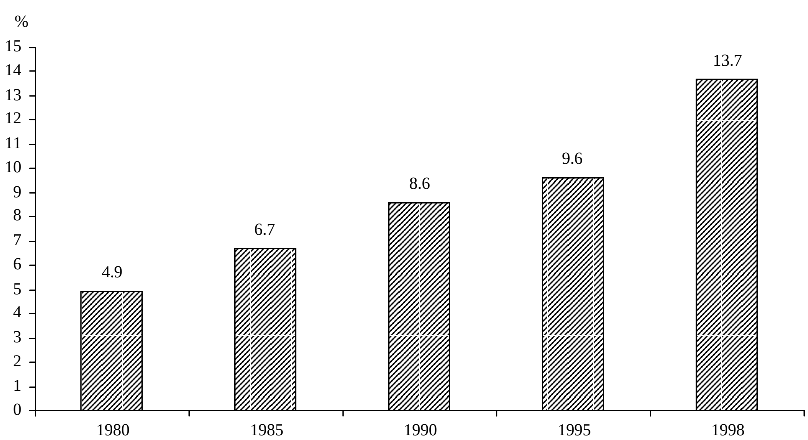
Furthermore, while booming FDI clearly points to increased international capital mobility, the contribution of FDI to gross fixed capital formation remained modest (Figure 3). World-wide FDI flows still accounted for less than 10 percent of gross fixed capital formation in the second-half of the 1990s. This ratio was only 2 percentage points higher in 1995-1998 than in the second-half of the 1980s. This implies that capital formation continues to be a national phenomenon in the first place.

Figure 1: World FDI Flows, US $ Billion and Percent of World Exports, 1980–1999



Source: UNCTAD (a); IMF (2000).

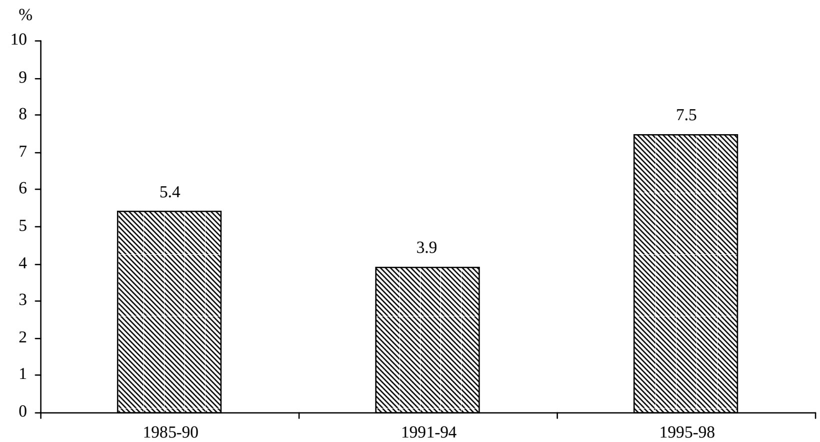
Figure 2: World-wide FDI Stocks[a], Percent of GDP, 1980–1998



[a]Inward FDI stocks.

Source: UNCTAD (a).

Figure 3: World FDI Inflows, percent of gross fixed capital formation, 1985–1998[a]



[a]Annual averages.

Source: UNCTAD (a).

Traditionally, FDI was a phenomenon that primarily concerned highly developed economies. Developed countries still attract a higher share of world-wide FDI than developing countries (Figure 4). In recent years, however, the increase in FDI flows to developing countries turned out to be higher than the increase in FDI flows to developed countries. Average annual FDI flows to developing countries soared eight-fold, when comparing 1982-1987 and 1994-1999. As a result, developing countries attracted almost one-third of world-wide FDI flows recently.

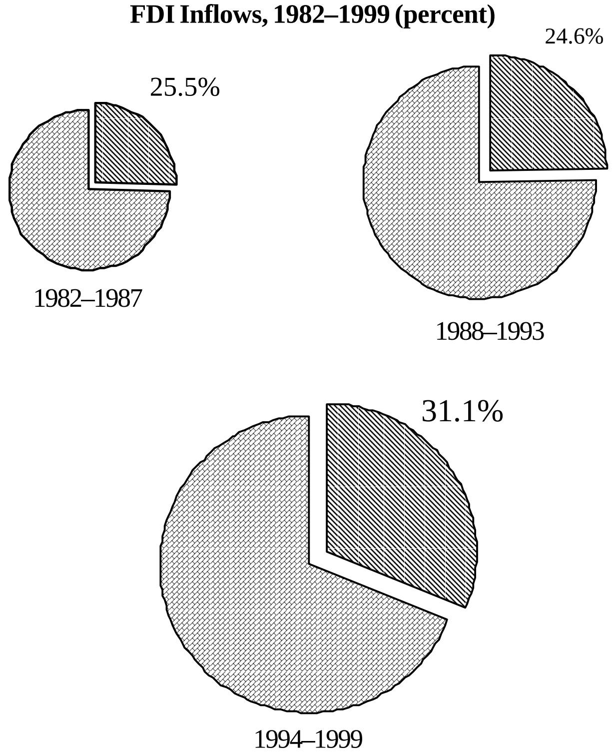
Moreover, in relative terms, FDI plays a more important role in developing countries than in developed countries. In the former, FDI inflows in 1994-1998 represented an average share of almost 10 percent of gross fixed capital formation, compared to 6 percent in developed countries (UNCTAD a). Inward FDI stocks of developing countries in 1998 amounted to 20 percent of their GDP, compared to 12 percent in developed countries.

Various groups of developing countries (including transition countries in Central and Eastern Europe) participated to a strikingly different degree in the FDI boom (Figure 5):

- The recent financial crisis notwithstanding, South, East and Southeast Asia emerged as the most important host region among developing countries. This group absorbed about half of FDI flows to all developing countries in the 1990s and left Latin America considerably behind in terms of attractiveness to FDI.

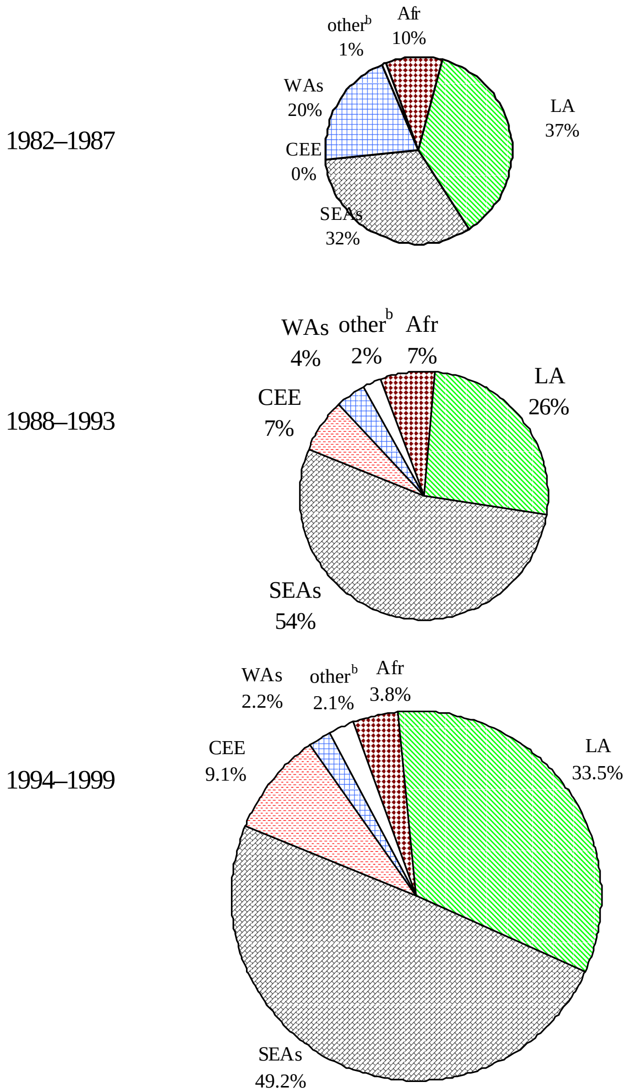
- Nevertheless, Latin America is back on the scene as an important host region. Average annual FDI flows to this region more than quadrupled, when comparing 1988-1993 and 1994-1999. Latin America's share in FDI flows to all developing countries recovered considerably and almost reached the level recorded in 1982-1987.

Figure 4: Share of All Developing Countries in World-wide FDI Inflows, 1982–1999 (percent)



Source: UNCTAD (a).

Figure 5: Regional Distribution of FDI Flows to Developing Countries[a], 1982–1999 (percent)



Afr=Africa; LA=Latin America; SEAs=South, East and Southeast Asia; WAs=West Asia; CEE=Central and Eastern Europe

[a]Including Central and Eastern Europe. – [b]Developing Europe, Central Asia and Pacific.

Source: UNCTAD (a).

- Apart from South, East and Southeast Asia, the second winner, in terms of FDI shares, is Central and Eastern Europe. This development is obviously related to the demise of the socialist regime in this region and the opening up towards world markets. The emergence of Central and Eastern Europe as a new competitor for FDI raised concern in various developing countries, e.g. in Latin America, that this would result in FDI diversion at their expense. However, there is hardly any evidence supporting this view.[2] For example, FDI by European investors in Latin America recovered precisely when Central and Eastern Europe emerged as a competitor for EU FDI. This suggests that the opening of Central and Eastern Europe induced additional FDI, rather than resulting in FDI diversion.

- In contrast to the aforementioned regions, Africa is frequently considered to be on the sidelines when it comes to participating in globalisation, in general, and attracting FDI, in particular. Figure 5 supports this view as Africa's share in FDI flows to all developing countries has steadily declined since the early 1980s. Nevertheless, average annual flows to Africa were 3.5 times higher in 1994-1999 than in 1982-1987. Hence, it seems to be overly pessimistic to argue that Africa has no reasonable chance to attract FDI (see also UNCTAD 1999).

- The situation appears to be worse in West Asia,[3] which represents the only region considered in Figure 5 where FDI inflows declined in absolute terms. Average annual inflows were cut half in 1988-1993, compared to 1982-1987. FDI flows to West Asia recovered thereafter, but average annual inflows in 1994-1999 were still slightly below the figure recorded in 1982-1987 (see Box for a more detailed presentation).

A widely perceived problem with FDI in developing countries concerns its high concentration in a few large and fairly advanced developing economies (e.g., UNCTAD 1995; Collins 1998). This notion seems to imply that most developing countries do not have favourable prospects to attract FDI. However, this concern is largely unjustified, as it is based on the distribution of FDI in absolute terms.

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2. For a detailed discussion, see Nunnenkamp (2000).
3. Note that the definition of West Asia in Figure 5 is according to UNCTAD's World Investment Report. This means that Turkey is included in West Asia, whereas Egypt is included in Africa. By contrast, Egypt is a member of the UN Economic and Social Commission for Western Asia (ESCWA), whereas Turkey is not.

The upper panel of Figure 6 lists the 20 top-performers among developing countries, measured by inward FDI stocks in 1998. This rather small group, indeed, accounted for more than 80 percent of inward FDI stocks in all developing countries. It is also true that the group of top-performers in absolute terms mainly consists of either large countries such as China, Brazil, Indonesia, Mexico and Argentina, or economies with fairly high per capita income such as Hong Kong and Singapore. This ranking provides a distorted picture on developing countries' attractiveness to FDI. Inward FDI stocks have to be considered in relative terms, in order to avoid a large-country bias and assess locational attractiveness appropriately.

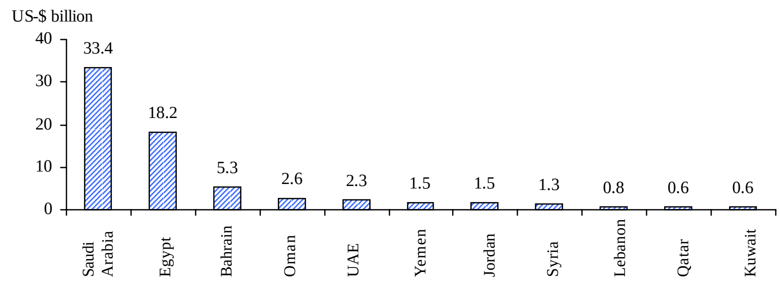
The lower panel of Figure 6 relates inward FDI stocks to the host countries' GDP. Caribbean tax havens and developing countries with a population of less than three million are excluded from this ranking both groups include economies with extremely high FDI/GDP ratios, which may be due to a few FDI projects in the case of very small countries. Even though the sample is reduced in this way, the ranking changes significantly when inward FDI stocks are considered in relative terms. Just eight of the 20 top-performers, in absolute terms, are also among the 20 top-performers in relative terms (see the shaded bars in Figure 6). Moreover, the distribution of inward FDI, in relative terms, is considerably less uneven than the distribution of absolute stocks.

Box: FDI Patterns in West Asia

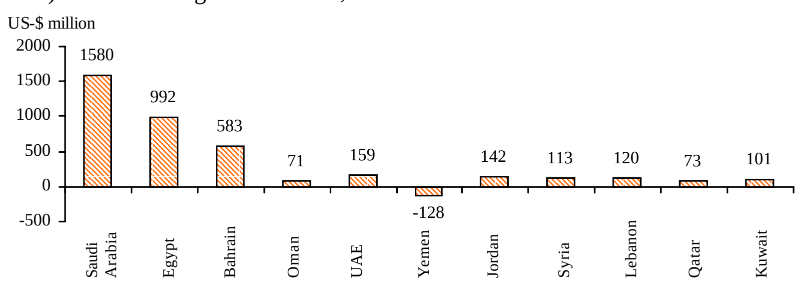
Just two members of the UN Economic and Social Commission for Western Asia (ESCWA), namely Egypt and Saudi Arabia, absorbed the bulk of FDI in this group of 13 countries. Egypt and Saudi Arabia accounted for more than three-quarters of inward FDI stocks in ESCWA countries (upper panel of box figure).

Attractiveness of ESCWA Countries to FDI in Absolute and Relative Terms[a]

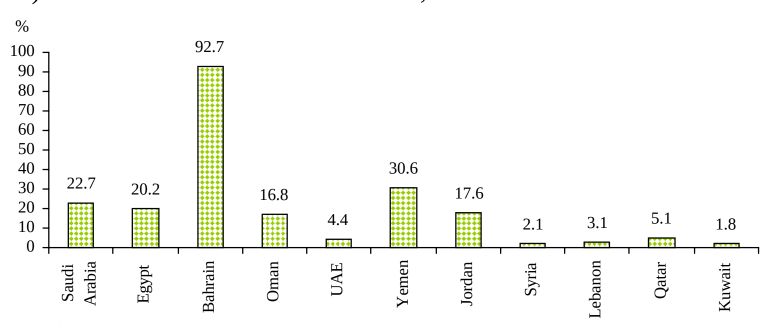
a) Inward FDI Stock, 1999



b) Annual Average FDI Inflows, 1994–99



c) Inward FDI Stock in Percent of GDP, 1998



[a] Data for Palestine and Iraq not available.

The decline of West Asia's share in FDI flows to all developing countries primarily reflects FDI patterns in Saudi Arabia. Saudi Arabia attracted exceptionally high FDI inflows in the early 1980s (accumulated inflows of US $27.4bn in 1981-1984), i.e. in the aftermath of the oil price shock of 1979/80. Since the mid-1980s, FDI flows to Saudi Arabia fluctuated heavily and turned significantly negative in various years, accumulated inflows were practically nil in 1985-1996, and boomed only thereafter. Considerable fluctuations were also reported for FDI flows to Egypt. However, annual inflows remained positive throughout the 1980s and 1990s (with a minimum of US $250mn in 1991, and a maximum of US $1.5bn in 1999).

FDI flows to the smaller ESCWA members were not only minor, compared to Egypt and Saudi Arabia, but also varying over time between inflows and outflows in various cases. Volatility is probably to be attributed to the relatively small number of FDI projects in these countries. Considering the period 1982-1999, a long-term trend of rising annual inflows is hardly discernible so far for any of these members. On a more positive note, average annual inflows were considerably higher in 1994-1999 than in 1988-1993 in most of the smaller ESCWA members, notably in Bahrain, Jordan and Lebanon. Major exceptions were Oman (with declining average annual inflows) and Yemen (where average annual inflows turned negative in 1994-1999).

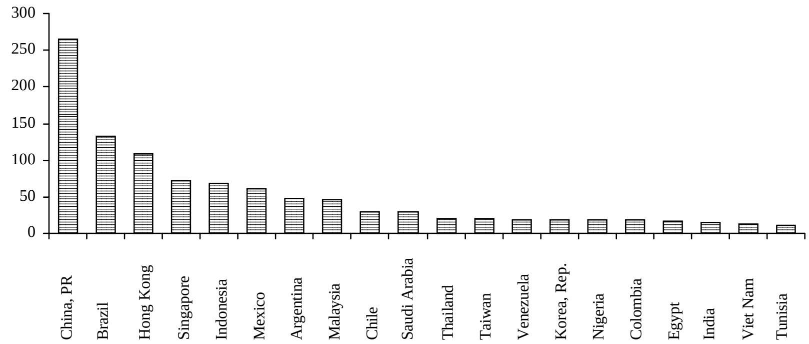
It is fairly difficult to draw firm conclusions from these observations. Yet, the evidence contradicts the pessimistic view that FDI in the ESCWA region is necessarily restricted to the two large players (i.e. Egypt and Saudi Arabia) and that the smaller members are, by definition, not attractive to FDI. First, the distribution of recent FDI flows to the region (second panel of box figure) is less skewed than overall FDI stocks. While less than a quarter of overall FDI stocks in the ESCWA group was located in (nine) relatively small members, these countries attracted almost one third of inflows in 1994-1999.

Second, Jordan and Lebanon, both of which received hardly any FDI in 1988-1993, ranked fifth and sixth among the ESCWA members in terms of average annual inflows in 1994-1999. Third, some of the smaller members are not far behind, or even ahead of, Egypt and Saudi Arabia, when their attractiveness to FDI is assessed in relative terms (see the lower panel of box figure for the FDI/GDP ratio). Also, within the group of relatively small members, similarly high FDI stocks, e.g. in Jordan and Syria, tend to disguise significant differences in locational attractiveness.

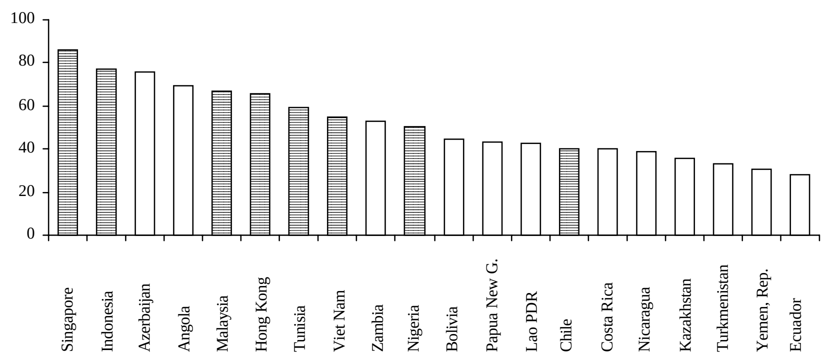
Source: UNCTAD (a, 2000).

Figure 6: Inward FDI Stocks: Top 20 Developing Countries[a], 1998

a) US $ billion



b) Percent of GDP[b]



a Excluding Caribbean financial centres.
b Excluding developing countries with a population of 3 million and less.
Source: UNCTAD (a, 2000).

In smaller and less advanced countries with high FDI/GDP ratios, FDI appears to be resource-based in various instances. However, resource-based FDI figures prominently in some of the absolutely largest recipients, too (notably in Saudi Arabia and Nigeria). Moreover, if countries such as Azerbaijan, Angola and Zambia were excluded from the lower panel of Figure 6, not only China (FDI/GDP ratio: 27.6 percent) but also countries such as Togo (26.4 percent), Côte d'Ivoire (24.2 percent), and Malawi (22.9 percent) would enter the group of the 20 top-performers.

According to the findings of UNCTAD (1999), services and manufacturing are key sectors for FDI in various African countries. Hence, a fairly heterogeneous set of relatively small and less advanced countries proved attractive to FDI in relative terms.[4] In conclusion, there is little justification for the pessimistic view, according to which just a few developing countries can draw on FDI.

4. This remains true when FDI is considered in per capita terms, instead of relating FDI to GDP. For instance, the per capita FDI stock in 1998 was higher in Costa Rica than in Brazil and Mexico. Angola proved more attractive by this measure than Egypt and Nigeria, and Papua New Guinea hosted a higher per capita FDI stock than Indonesia, Thailand and Viet Nam. In per capita terms, seven out of the twelve relatively small and less advanced countries included in the lower panel of Figure 6 (see the non-shaded bars) were more attractive to FDI than China, which was the top-performer in absolute terms.

III
FDI Determinants:
What Matters for Developing Countries?

The subsequent account of FDI determinants focuses on location-specific factors. Firm-specific factors are ignored, as they cannot be influenced by host country governments.[5] As noted before, our knowledge is fairly limited regarding the relative importance of different location-specific FDI determinants.[6]

The relative importance of some determinants is likely to vary between different types of FDI, i.e. resource-seeking, market-seeking and efficiency-seeking FDI. Furthermore, the relative importance of FDI determinants may change over time, e.g. due to ongoing globalisation. Figure 7 groups important location-specific factors into three categories, i.e. the overall policy framework for FDI, economic determinants and business facilitation measures.[7]

1. Overall Policy Framework: Diminishing Returns of FDI Liberalisation?
The overall policy framework comprises quite heterogeneous elements, such as economic and political stability as well as regulations governing the entry and operations of trans-national corporations (TNCs). These elements share one important characteristic, however: they may be intended to induce FDI, but it is open to question whether TNCs will actually react in the expected manner. This is because overall stability and openness to FDI are necessary conditions for FDI, whereas these factors are far from sufficient to induce FDI.

5. According to the widely known OLI (ownership, location, internalisation) framework (Dunning 1993), firm-specific factors concern competitive advantages in a trans-national corporation and commercial benefits in an intra-firm relationship (as against an arm's-length relationship, e.g., between an exporting company and an importing counterpart).
6. Singh and Jun (1995: 4) conclude: "A broad consensus on the major determinants of FDI has been elusive."
7. This classification draws on UNCTAD (a, 1998: Chapter IV).

For example, the liberalisation of national FDI frameworks has become the dominant type of FDI policy change in dozens of developing countries since the mid-1980s (UNCTAD a, 1998: 93 ff.). Likewise, the number of developing countries that have signed bi- or multilateral agreements, ensuring a liberal treatment of FDI and its protection after entry, increased dramatically in the 1990s. Nevertheless, FDI inflows have remained small in many of these liberalising countries.

TNCs tend to take more liberal FDI regimes for granted, and consider the convergence of FDI regimes to be the natural consequence of globalisation. As a result, the liberalisation of FDI regulations may be characterised by diminishing returns. Developing countries not taking part in the general move towards liberalisation are likely to suffer negative effects of restrictive policies on FDI inflows. But, a liberal FDI regime does little more than enabling TNCs to invest in a host country. It is a completely different question whether FDI will actually be forthcoming as a result of FDI liberalisation.

There may be one major exception to this line of reasoning among the factors listed in Figure 7 under "overall policy framework", namely, privatisation. While the trend towards privatising state-owned enterprises is almost as broadly based in developing countries as the liberalisation of FDI regulations, privatisation differs from the latter in that it did induce substantial FDI inflows in various developing countries. Prominent cases include Latin American countries and transition economies in Central and Eastern Europe.[8]

Privatisation contributed significantly to two structural shifts in the composition of FDI flows to developing countries:

- the rising share of FDI in services, as privatisation, notably in Latin America, involved service industries in the first place; and
- the growing importance of mergers and acquisitions (M&As), as opposed to greenfield investment.

Yet, privatisation-induced FDI is controversially discussed for several reasons. First, FDI related to the sale of state-owned enterprises is frequently said to leave the overall volume of investment unaffected. This is true in the sense that M&As, in contrast to greenfield investment, are no more than a change in ownership (the same is obviously true when public assets are sold to domestic private investors). Whether or not M&As increase overall investment depends on the use of government revenues from privatisation. Second, privatisation-related FDI may be problematic from a competition-policy point of view. In the

8. On Latin America, see Nunnenkamp (1997) and the literature given there.

case of “natural monopolies”, a state monopoly would be replaced by a private monopoly (again this also applies when public assets are sold to domestic private investors). Hence, privatisation should go along with trade liberalisation and competition policies, preventing the misuse of monopoly power and enhancing competition by breaking up monopolies.

Third, privatisation-related FDI is often believed to be a one-off event. This is not necessarily true, however. Privatisation contracts may specify further investment to be undertaken after the original purchase. Changes in ownership have frequently been associated with significant additional investment in the rationalisation and modernisation of privatised firms. Reinvested earnings of firms, which foreign investors acquired through privatisation, may lead to FDI flows beyond those associated with the initial transaction. Finally, privatisation programmes help improve the climate for FDI in indirect ways, e.g., by indicating the government’s commitment to economic reform. Hence, privatisation-related FDI may prove to be the gateway to higher FDI inflows on a regular basis.

2. Economic Factors: Traditional Determinants on the Decline?

It is mainly with regard to economic determinants of FDI that the investors’ motivations for undertaking FDI are relevant (Figure 7). Three major types of FDI are typically differentiated: resource-seeking FDI, market-seeking FDI and efficiency-seeking FDI.

Resource-seeking FDI is motivated by the availability of natural resources in host countries. This type of FDI was historically fairly important and remains a relevant source of FDI for various developing countries. On a world-wide scale, however, the relative importance of resource-seeking FDI decreased significantly. The share of the primary sector in outward FDI stocks of major home countries was below 5 percent in the first-half of the 1990s (UNCTAD a, 1998: 106).

The relative decline of resource-seeking FDI may, at least partly, explain FDI patterns in countries such as Saudi Arabia (see also box above). The decline is not only because natural resources account for a decreasing share of world output. At the same time, FDI may no longer be the preferred mode of drawing on natural resources (such as oil).

FDI was favoured over trade in the past, when resource-abundant countries lacked the large amounts of capital required for resource extraction or did not have the necessary technical skills. FDI tends to give way to joint ventures, non-equity arrangements with foreign investors and arm’s-length trade relations when host countries are no longer constrained in terms of capital and technical skills and are, thus, able to set up competitive indigenous enterprises.

Figure 7: Selected Host Country Determinants of FDI

Overall Policy Framework

- economic and political stability
- rules regarding entry and operations of TNCs
- bi- and multilateral agreements on FDI
- privatisation policy

Business Facilitation

- administrative procedures
- FDI promotion (e.g., facilitation services)
- FDI incentives (subsidies)

Economic Determinants[a]

1. Relating to Resource-seeking FDI	*2. Relating to Market-seeking FDI*	*3. Relating to Efficiency-seeking FDI*
• raw materials	• market size	• productivity-adjusted labour costs
• complementary factors of production (labour)	• market growth	• sufficiently skilled labour
• physical infrastructure	• regional integration	• business-related services • trade policy

[a]Differentiated by major motivations of FDI.

Source: Adapted from UNCTAD (a, 1998: Table IV.1).

The relative importance of market-seeking FDI is fairly difficult to assess. It is almost impossible to tell whether this type of FDI has already become less important due to economic globalisation. Regarding the history of FDI in developing countries, various empirical studies have shown that the size and growth of host country markets were among the most important FDI determinants.[9] It is debatable, however, whether this is (and will be) still true with ongoing globalisation.

Traditionally, FDI was the only reasonable means to penetrate local markets in various developing countries. For instance, exporting to Latin America was no

9. Earlier studies are surveyed in Agarwal (1980); for a more recent overview, see Singh and Jun (1995) as well as UNCTAD (a, 1998: 135 ff.).

promising alternative to investing there as local industries were heavily protected (Nunnenkamp 1997). FDI was used to circumvent import barriers. The situation has changed considerably in recent times. Many developing countries have liberalised their import regime, thereby enabling TNCs to choose between exporting or undertaking FDI. As a consequence, purely market-seeking FDI may decline. UNCTAD (a, 1996: 97) argued that "one of the most important traditional FDI determinants, the size of national markets, has decreased in importance", even though conclusive empirical evidence is hard to come by.

It should also be taken into account that the possible decline of market-seeking FDI is largely restricted to FDI in manufacturing industries. On the other hand, market-seeking FDI received a major push by the opening of service industries to FDI. The bulk of FDI in services, which accounts for a rising share in overall FDI, is market-seeking almost by definition, as most services are not tradable in the sense of cross-border transactions.

Arguably, the decline of market-seeking FDI in manufacturing may also be counteracted by regional integration. Policy-makers all over the world consider regional integration to be instrumental in inducing FDI. The basic argument underlying this hope is that regional integration increases market size and enhances economic growth (IDB and IRELA 1996: 57 ff.; UNCTAD 2000: 21). The process of EU integration as well as Mexico's membership in NAFTA are frequently referred to when looking for empirical support to the reasoning that regional integration promotes FDI.

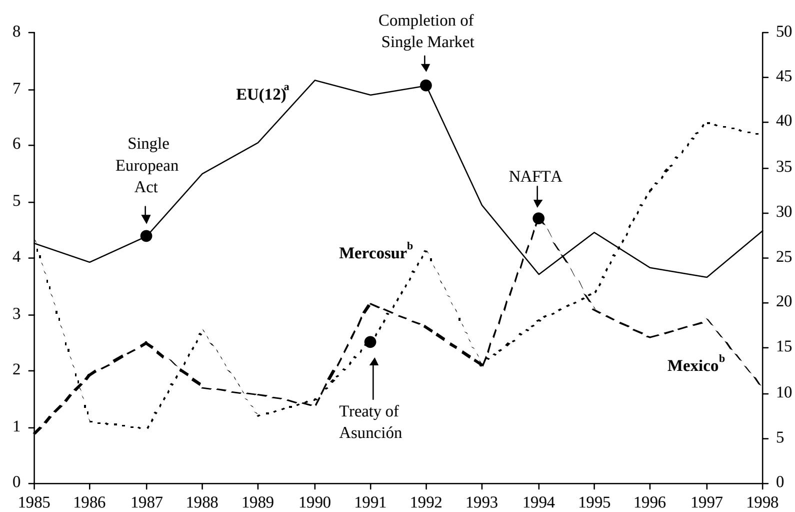
I have argued elsewhere that the two examples do not provide a completely compelling case for an integration-induced rise in FDI (Nunnenkamp 2001b). The effects of regional integration remained temporary in both cases (Figure 8). Apart from the duration of integration-induced effects on FDI, it is for several other reasons that the relation between regional integration and FDI is neither self-evident nor straightforward (Blomström and Kokko 1997). First, it is extremely difficult, if not impossible, to separate integration-induced effects from other influences on FDI, notably, policy reforms on the national level.

Second, integration-induced FDI may be concentrated in some member countries of regional integration schemes, while other member countries do not benefit at all. Third, an increase in market-seeking FDI does not necessarily go along with an increase in overall FDI. The positive effect of higher market-seeking FDI may be offset if regional integration undermines the incentives to efficiency-seeking FDI by raising trade barriers against non-member countries.

We are, thus, back to the question whether economic globalisation has changed (or will change) the rules of the game in competing for FDI. In various developing countries, market-seeking FDI was concentrated in sophisticated manufacturing industries in which host countries lacked comparative advantage. Import protection supported high rates of return so that the efficiency and international competitiveness of market-seeking FDI was not a major concern of foreign investors (UNCTAD a, 1998: 253). By contrast, international competitiveness of local production, including local production by foreign investors, becomes the critical factor if globalisation alters the form and purpose of FDI.

Globalisation, essentially, means that geographically dispersed manufacturing, slicing up the value chain and the combination of markets and resources through FDI and trade are becoming major characteristics of the world economy. Efficiency-seeking FDI, i.e. FDI motivated by creating new sources of competitiveness for firms and strengthening existing ones, may then emerge as the most important type of FDI. Accordingly, the competition for FDI would be based increasingly on cost differences between locations, the quality of infrastructure and business-related services, the ease of doing business and the availability of skills.

Figure 8: Regional Integration and Attractiveness to FDI: FDI Flows to EU, Mercosur and Mexico (share in world-wide flows), 1985-1998



[a]Right-hand scale. [b]Left-hand scale.

Source: World Bank, World Development Indicators, CD-RoM.

This scenario, obviously, involves major challenges for developing countries, ranging from human capital formation to the provision of business-related services such as efficient communication and distribution systems. Put differently, the challenge is to create assets that can provide a competitive edge. Furthermore, it may turn out to be critically important to realise that FDI and trade would no longer be substitutes, but rather be driven by a common set of determinants. Developing countries, which were to restrict imports of capital goods and intermediate products, would have no reasonable chance to become integrated into international sourcing and marketing networks of TNCs.

3. Business Facilitation: Costly, but not Effective?

To a large extent, business facilitation relates to one of the factors mentioned already in the context of efficiency-seeking FDI, namely, the ease of doing business. However, as indicated in Figure 7, promotional efforts may well go beyond narrowly-defined business facilitation and include fiscal and tax incentives. The latter are what Charles Oman (2001) has rightly labelled as the perils of competition for FDI.

Business facilitation is, typically, dealt with by investment promotion agencies (IPAs):

- Investment-generating measures of IPAs include FDI campaigns, industry-specific FDI missions and targeting particular TNCs. Particularly, the latter reveals the shift of IPAs' activities from image-building to more specific FDI generation. A survey conducted in the mid-1990s among 81 IPAs showed that a great majority of them tried to identify and attract foreign investors (UNCTAD a, 1998: 101).
- Investment-facilitation services consist of counselling, speeding up the approval process and assistance in obtaining permits. These services are often provided by "one-stop shops".
- In addition, after-investment services related to day-to-day operational matters are offered to established foreign investors.

Underlying many of these measures is the governments' wish to do more in terms of pro-active policies, given that FDI liberalisation alone suffers from diminishing returns. However, there is a trend towards a convergence of policies and practices, not only with regard to FDI liberalisation but also in the area of business facilitation. This may have tempted governments to enter into another race of competing for FDI by offering tax incentives and outright subsidies.

"Bidding wars" among governments may create major distortions in the allocation of investment resources. Subsidies discriminate against sectors and projects not targeted by incentives. Especially smaller investors and local investors may suffer discrimination. Moreover, "bidding wars" may be very costly and weaken public finances. While these costs are difficult to measure, Oman (2001) collected some evidence, according to which subsidies granted to foreign investors in the automobile industry soared from less than US$20,000 per job created in the early 1980s to more than US $200,000 in several instances in the 1990s. UNCTAD (a, 1998: 102) noted that the use of investment incentives has proliferated; the range of incentives to foreign investors and the number of countries that offer incentives have both increased since the mid-1980s.

Incentives-based competition for FDI has become pervasive not only among national governments, but also among sub-national authorities (Oman 2001). Moreover, this type of competition is particularly fierce among neighbours, e.g. governments in the same region. This may render it fairly difficult to strengthen co-operation among IPAs in a regional context. It is at least questionable whether competing agencies are eager to engage in an exchange of expertise and experience, unless they realise that "bidding wars" are counterproductive and unlikely to induce more FDI.

Economists have long argued that the use of discretionary fiscal and financial subsidies to attract FDI is ineffective. This is one of the few FDI-related issues on which economists tend to agree.[10] Ironically, it is precisely where economists claim to have presented conclusive results that the gulf between expert advice and actual policy-making is particularly wide. Policy-makers argue that, even though discretionary incentives do not rank high among major FDI determinants, such incentives can make a difference at the margin. Investment decisions of foreign investors are considered to be a two-stage process: after the location is broadly determined and potential candidates within a region are short-listed according to economic fundamentals, the final site selection may be influenced by fiscal and financial incentives.

This reasoning is plausible, but the major problem facing policy-makers remains: incentives-based competition among short-listed countries may easily degenerate into costly "bidding wars". Pro-active FDI policies are a two-edged sword. A co-operative approach may help prevent costly "bidding wars", but the difficulties in orchestrating and enforcing effective co-operation among competitors should not be underestimated, not least because co-operation must involve local authorities, in addition to national governments. The real test comes when investors start playing governments off against each another to bid up the value of incentives. Moreover, it should be kept in mind that no promotional efforts or incentives will help attract significant FDI, if economic and political fundamentals are not conducive to FDI.

10. For a survey, see Pirnia (1996).

IV
Growth Effects of FDI: Insufficiently Explored Territory

FDI is widely considered an essential element for achieving sustainable development. Even former critics of TNCs, e.g. UNCTAD, expect FDI to provide a stronger stimulus to income growth in host countries than other types of capital inflows. Especially after the recent financial crises in Asia and Latin America, developing countries are strongly advised to rely primarily on FDI, in order to supplement national savings by capital inflows and promote economic development.

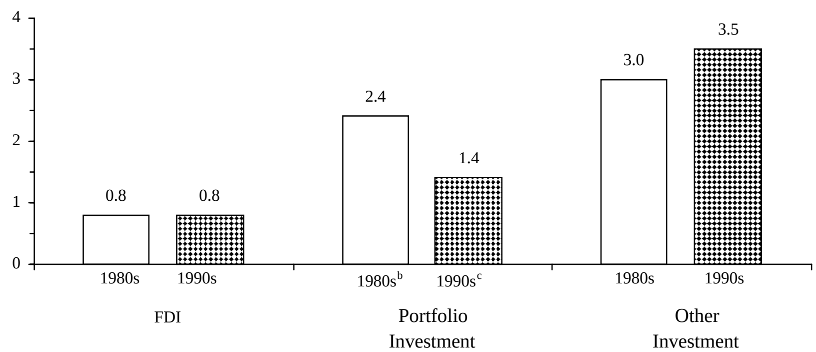
FDI is perceived superior to other types of capital inflows for several reasons:

- In contrast to foreign lenders and portfolio investors, foreign direct investors, typically, have a longer-term perspective when engaging in a host country. Hence, FDI inflows are less volatile and easier to sustain at times of crisis.
- While debt inflows may finance consumption rather than investment in the host country, FDI is more likely to be used productively.
- FDI is expected to have relatively strong effects on economic growth, as FDI provides for more than just capital. FDI offers access to internationally available technologies and management know-how, and may render it easier to penetrate world markets.

The risk-sharing properties of FDI are undisputed. This suggests that FDI, indeed, is the appropriate form of external financing for developing countries, which have less capacity than highly developed economies to absorb external shocks. Likewise, the evidence supports the predominant view that FDI is more stable than other types of capital inflows.[11] In Figure 9, the volatility of different capital inflow items is compared by taking the coefficient of variation (standard deviation divided by mean) as a measure of volatility. FDI clearly turns out to be the most stable item. Moreover, the volatility of FDI remained exceptionally low in the 1990s, when several emerging economies were hit by financial crises.

11. For a more detailed discussion, see Nunnenkamp (2001a).

Figure 9: Volatility of Different Types of Capital Flows in the 1980s and 1990s (coefficient of variation)[a]



[a]Standard deviation divided by mean. Average of country-specific coefficients of variation (absolute value) for 13 Asian and Latin American countries (annual data). – [b]Without Chile, Mexico, Peru and Venezuela. – [c]1.3 without countries listed in note b.

Source: IMF (2000).

The former Chief Economist of the Inter-American Development Bank, Ricardo Hausmann, has disagreed that FDI may appear more stable than it is, as TNCs may use other ways than repatriating FDI to leave the country: "If a foreign firm saw a crisis coming and wanted to take money out...it would borrow domestically and buy foreign assets or repay foreign loans" (Fernández-Arias and Hausmann 2000: 4). Though related to FDI, outflows would be generated under an account other than FDI. The empirical evidence of round-tripping of this sort is open to question. It is hard to imagine, however, that it is as widespread to account for the pronounced differences in volatility reported in Figure 9.

The second perceived advantage of FDI, i.e. its investment-increasing property, is more debatable. FDI in the form of M&As is simply a change in ownership and its effects on overall investment, thus, depend on the use of domestic resources released by the sale of assets to foreign investors. By contrast, greenfield investment has an immediate impact on overall investment. It cannot be ruled out, however, that FDI in the form of greenfield investment crowds out domestic investment.

Hence, it is essentially an empirical question whether FDI raises overall investment. The results depend on whether this question is analysed in a cross-country context or in a time-series context. The cross-country study of Borensztein et al. (1998) revealed a strong positive effect of FDI on domestic capital formation.

Other cross-country studies, too, rejected the proposition that FDI crowds out domestic investors. The results of time-series studies are summarised as follows by Lipsey (2000: 74): “We are warned not to expect too much from the time-series effects of FDI on growth from effects on fixed investment.” According to Lipsey’s own regressions, past FDI inflows are not a significant positive influence on the current period’s investment ratio.

The evidence is also mixed when it comes to the economic growth effects of FDI. UNCTAD (a, 1999) fails to identify direct effects of FDI on economic growth, even though various estimates are presented (many of which are specified in an ad-hoc manner). According to Borensztein et al. (1998), FDI as such has no significant growth effects when included as an independent variable in the regression equation.

However, these authors show that FDI contributes to economic growth when an interaction term, i.e. the product of FDI and a measure of human capital (secondary school attainment), enters the regression. This suggests that FDI contributes to economic growth only when a sufficient absorptive capability of advanced technologies is available in the host country: the higher the level of education of the labour force, the greater the gain in growth from a given FDI inflow.

Two recent studies, which compare the growth effects of FDI with the growth effects of other capital inflow items, have come up with opposing results:

- A study by the OECD Development Centre supported the hypothesis that FDI is superior to foreign debt (Soto 2000). FDI (and portfolio equity flows) exhibit a robust positive correlation with growth. By contrast, debt-related inflows are negatively correlated with the growth rate in economies with undercapitalised banking systems. Accordingly, developing countries are advised to encourage FDI.
- This conclusion is rejected by Hausmann and Cortés (2001). These authors show the growth effects of FDI inflows to be weaker than the growth effects of long- and short-term debt inflows.

In summary, strongly positive growth effects of FDI cannot be taken for granted. The ambiguous – and sometimes contradictory – empirical findings indicate that FDI must no longer be considered to be a homogenous phenomenon, as done in the studies referred to above, in order to improve our understanding of the growth impact of FDI (Nunnenkamp 2000b). According to simple correlation analyses, it depends on time-varying and location-specific factors whether FDI and growth are positively correlated altogether, and which of these variables leads or lags the other. For example, opening up early to FDI inflows, combined with close integration into world trade, seems to have strengthened the FDI/growth nexus. The good news for small and less advanced economies is that, according to this correlation exercise, they can benefit from positive growth effects of FDI as much as large and more advanced developing countries.

V
Summary and Conclusions

Economic globalisation went along with booming FDI in developing countries, which attracted a rising share of world-wide FDI flows in the 1990s. In various developing countries, FDI plays a more significant role than in developed countries. The good news is that FDI is anything but a zero-sum game, in which one particular country could attract FDI only at the expense of another country. Additional FDI is likely to take place when new investment opportunities emerge in countries opening up to FDI. Essentially, all developing countries have the chance to become attractive to foreign investors, not only large and fairly advanced countries.

When competing for FDI, policy-makers have to be aware that various measures intended to induce FDI are necessary, but far from sufficient to do the trick. For example, this applies to the liberalisation of FDI regulations and various business facilitation measures. Other reforms, such as privatisation, tend to be more effective in stimulating FDI inflows, but need to be complemented by reform in further areas (e.g. competition policy), in order to ensure that FDI inflows are beneficial. Still other determinants of FDI, which were sufficient in the past, may prove to be less relevant in the future. The size of local markets appears to be the most important case in point.

Globalisation can be expected to induce a shift from market-seeking FDI to efficiency-seeking FDI. International competitiveness of local production by foreign investors will, then, turn out to be a decisive factor shaping the distribution of future FDI. This involves major challenges for policy-makers in developing countries.

In general terms, the task is to create (immobile) domestic assets that provide a competitive edge and attract internationally mobile factors of production. This task has various dimensions, ranging from human capital formation and capacity-building (in order to be able to absorb advanced technologies applied by foreign investors) to the provision of efficient business-related services. Furthermore, the policy agenda includes critical trade policy choices: liberalising trade in capital goods and intermediate products is essential in competing for efficiency-seeking FDI.

There is some bad news as well. Promotional efforts will help little, if at all, to attract FDI if economic fundamentals are not conducive to FDI. Fiscal and financial incentives offered to foreign investors may do more harm than good, especially if incentives discriminate against small investors and local firms. Policy-makers should not ignore the – direct and indirect – costs of discretionary FDI incentives.

Finally, policy-makers should not expect too much from FDI inflows. The recent boom of FDI notwithstanding, capital formation continues to be a national phenomenon in the first place. Strongly positive growth effects of FDI cannot be taken for granted. FDI is superior to other types of capital inflows in some respects, particularly because of its risk-sharing properties, but not necessarily in all respects. The nexus between FDI and overall investment as well as economic growth in host countries is neither self-evident nor straightforward, but remains insufficiently explored territory.

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