ONE STRIKING feature of the world economy in recent decades has been the growth of foreign direct investment (FDI), or investment by transnational corporations or multinational enterprises in foreign countries in order to control assets and manage production activities in those countries.

**Growth of FDI**

Since the early 1980s, world FDI flows, now attributable to almost 54,000 transnational corporations, have grown rapidly—faster than either world trade or world output (Table 1). During 1980–97, global FDI outflows increased at an average rate of about 13 percent a year, compared with average rates of 7 percent both for world exports of goods and nonfactor services and for world GDP (at current prices) during 1980–96. In 1998, global FDI inflows increased for the seventh consecutive year, and outflows for the third consecutive year, to reach some $430–440 billion. (In principle, world FDI flows measured in terms of annual inflows should be equal to those measured in terms of annual outflows. In practice, however, because of differences in national methodologies and coverage, they are not.)

The increase in direct investment flows has laid the foundation for a marked expansion of international production by transnational corporations, which now have an estimated $3.4 trillion invested in about 449,000 foreign affiliates throughout the world. The value of

**Foreign Direct Investment in Developing Countries**

Foreign direct investment has grown at a phenomenal rate since the early 1980s, and the world market for it has become more competitive. Developing countries are becoming increasingly attractive investment destinations, in part because they can offer investors a range of “created” assets.

*Padma Mallampally and Karl P. Sauvant*
sales by these foreign affiliates has increased more rapidly than that of foreign trade (world exports), reaching an estimated $9.5 billion.

As FDI flows have grown in volume, they have also become more widely dispersed among home (outward investor) and host (recipient) countries. Developing countries’ share in total FDI inflows rose from 26 percent in 1980 to 37 percent in 1997, and their share in total outflows rose from 3 percent in 1980 to 14 percent in 1997. Firms based in industrial countries are still the primary source of FDI, but direct investment originating in developing countries has more than doubled since the mid-1980s. Industrial countries as a group also attract the greater proportion of such investment, but their share is eroding as developing countries become increasingly attractive destinations for investment.

Among developing countries, though, the distribution of world FDI inflows is uneven. In 1997, for example, developing Asia received 22 percent; Latin America and the Caribbean, 14 percent; and Africa, 1 percent. In relative terms, however, the picture looks different: expressed as a ratio of gross fixed capital formation, FDI inflows to Africa were 7 percent in 1996, compared with 13 percent for Latin America and the Caribbean and 7 percent for developing Asia. In other words, inflows to Africa have a greater impact on the countries of that continent in relative terms than the absolute figures suggest.

### Table 1

<table>
<thead>
<tr>
<th>Selected indicators of foreign direct investment (FDI) and international production, 1986–97</th>
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<tr>
<td><strong>Value at current prices</strong> (billion dollars)</td>
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<tr>
<td>FDI inflows</td>
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<td>FDI outflows</td>
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<td>FDI inward stock</td>
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<td>Cross-border mergers and acquisitions</td>
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<td>Sales of foreign affiliates</td>
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<td>Gross product of foreign affiliates</td>
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<td>Total assets of foreign affiliates</td>
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**Memorandum:**

- GDP at factor cost: 28,822 | 30,551 | 12.1 | 5.5 | 0.8 | 6.0 |
- Gross fixed capital formation: 5,136 | 5,393 | 12.5 | 2.6 | -0.1 | 5.0 |
- Royalties and fees receipts: 53 | 61 | 21.9 | 12.4 | 8.2 | 15.0 |
- Exports of goods and nonfactor services: 6,245 | 6,432 | 14.6 | 8.9 | 2.9 | 3.0 |


Note: Worldwide sales, gross product, and total assets of foreign affiliates are estimated by extrapolating the worldwide data on foreign affiliates of transnational corporations from France, Germany, Italy, Japan, and the United States for worldwide sales, those from the United States for gross product, and those from Germany and the United States for assets, on the basis of the shares of those countries in the worldwide inward FDI stock. Not included in this table are the value of worldwide operations by foreign affiliates associated with their parent firms through nonequity relationships and the sales of the parent firms themselves.

1 Majority-held investments only.
2 1987–90 only.
3 Projection on the basis of 1995 figures.
4 Estimates.

### Significance for developing countries

FDI has become an important source of private external finance for developing countries. It is different from other major types of external private capital flows in that it is motivated largely by the investors’ long-term prospects for making profits in production activities that they directly control. Foreign bank lending and portfolio investment, in contrast, are not invested in activities controlled by banks or portfolio investors, which are often motivated by short-term profit considerations that can be influenced by a variety of factors (interest rates, for example) and are prone to herd behavior. These differences are highlighted, for instance, by the pattern of bank lending and portfolio equity investment, on the one hand, and FDI, on the other, to the Asian countries stricken by financial turmoil in 1997: FDI flows in 1997 to the five most affected countries remained positive in all cases and declined only slightly for the group, whereas bank lending and portfolio equity investment flows declined sharply and even turned negative in 1997.

While FDI represents investment in production facilities, its significance for developing countries is much greater. Not only can FDI add to investible resources and capital formation, but, perhaps more important, it is also a means of transferring production technology, skills, innovative capacity, and organizational and managerial practices between locations, as well as of accessing international marketing
networks. The first to benefit are enterprises that are part of transnational systems (consisting of parent firms and affiliates) or that are directly linked to such systems through non-equity arrangements, but these assets can also be transferred to domestic firms and the wider economies of host countries if the environment is conducive. The greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spillovers (that is, indirect effects) from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competitiveness will spread. In these respects, as well as in inducing transnational corporations to locate their activities in a particular country in the first place, policies matter.

**Trends in developing countries**

Given the potential role FDI can play in accelerating growth and economic transformation, developing countries are strongly interested in attracting it. They are taking steps to improve the principal determinants influencing the locational choices of foreign direct investors (Table 2).

**Policy framework.** Developing countries have, during the past decade or so, begun liberalizing their national policies to establish a hospitable regulatory framework for FDI by relaxing rules regarding market entry and foreign ownership, improving the standards of treatment accorded to foreign firms, and improving the functioning of markets. These “core” policies are important because FDI will simply not take place where it is forbidden or strongly impeded. However, changes in policies have an asymmetric effect on the location of FDI: changes in the direction of greater openness allow firms to establish themselves in a particular location, but do not guarantee that they will do so. In contrast, changes in the direction of less openness (for example, nationalization or closure to entry) will ensure a reduction in FDI.

FDI policy frameworks are only one determinant of the location of investment among host countries. Countries must also pay attention to other factors that influence investors’ locational decisions. For example, they are emphasizing coherence between the various policies that can affect FDI—in particular, between core FDI policies and trade policies. In addition, they have negotiated an increasing number of bilateral investment treaties and double-taxation treaties. At the end of 1997, 1,513 bilateral investment treaties and 1,794 double taxation treaties were in effect; 153 of the former and 108 of the latter were concluded in 1997 alone. Both types of treaty reflect the growing role of FDI in the world economy and countries’ desire to facilitate it.

Equally important, with FDI policy frameworks becoming more similar, countries interested in encouraging investment inflows are focusing on measures that facilitate business. These include investment promotion, investment incentives,
after-investment services, improvements in amenities, and measures that reduce the “has-
sle” costs of doing business. While by no means new, these measures have proliferated and are
becoming more sophisticated, targeting indi-
vidual investors and investments in particular
industries. After-investment services are note-
worthy because they can encourage reinvest-
ment by existing investors, who, if satisfied,
provide publicity for the host country, sparking
further investment. Financial or fiscal incentives
are also used to attract investors, even though
they typically figure into investors’ location
decisions only when the economic determin-
ants are in place.

Economic determinants. The most important
determinants for the location of FDI are eco-
nomic considerations, which come into full
play once an enabling FDI policy framework is
in place. They may be divided into three groups
(Table 2): those related to the availability of
location-bound resources or assets; those
related to the size of markets for goods and ser-
ices; and those related to cost advantages in
production. Although many of the factors that
attract investment to particular locations—
such as abundant natural resources; large host
country markets; or low-cost, flexible labor—
remain important, their relative importance is
changing as transnational corporations, within
the context of a globalizing and liberalizing
world economy, increasingly pursue new strate-
gies to enhance their competitiveness.

Trade liberalization and FDI and technology
flows, combined with deregulation and privatiza-
tion, have not only improved firms’ access to
markets for goods and services and to immobile
factors of production but also increased com-
petitive pressures in previously protected mar-
kets, forcing firms to seek new markets,
resources, and assets abroad. At the same time,
technological advances have enhanced firms’ ability to coor-
dinate international production networks. More and more,
firms are developing portfolios of locational assets—human
resources, infrastructure, and market access—to complement
their own strengths in order to improve their overall competi-
tiveness. While traditional motives related to FDI (market-
seeking, resource-seeking, and efficiency-seeking) have not
disappeared, they are being incorporated into firms’ broader
competitive-enhancing strategies. These have evolved from
the traditional stand-alone strategies based on largely
autonomous production by foreign affiliates, to simple inte-
gration strategies based on a limited number of strong links
at the production level, to complex integration strategies that
involve, where profitable, splitting the production process
into specific activities or functions and per-
forming each of them in the most cost-effective
location from the viewpoint of the corporate
system as a whole.

Transnational corporations looking to invest
not only take for granted the presence of state-
of-the-art FDI policy frameworks and a range
of business facilitation measures but also seek a
combination of cost reduction, larger markets,
and “created” assets that can help them main-
tain a competitive edge. Created assets include
communications infrastructure, marketing net-
works, technology, and innovative capacity and
are critical for enabling firms to maintain their
competitiveness in a rapidly changing world.
The rising importance of such assets is proba-
bly the single most important shift that has
occurred among the economic determinants
of FDI in a liberalizing and globalizing world
economy. The new configuration also pays
more attention to “agglomeration” economies
arising from the clustering of economic activ-
ity, availability of infrastructure facilities, access
to regional markets, and competitive pricing of
relevant resources and facilities.

The challenge for developing countries is
to develop a well-calibrated and, preferably,
unique combination of factors determining
FDI location and to match those determinants
with corporations’ strategies. Policies intended
to strengthen national innovation systems and
encourage the spread of technology are central
because they underpin the ability to create
assets.

Conclusion

Recognizing that FDI can contribute to eco-
nomic development, all governments want to
attract it. Indeed, the world market for such
investment is highly competitive, and develop-
ing countries, in particular, seek such invest-
ment to accelerate their development efforts. With liberal
policy frameworks becoming commonplace and losing some
of their traditional power to attract FDI, governments are
paying more attention to measures that actively facilitate it.
Still, the economic determinants remain key. What is likely to
be more critical in the future is the distinctive combination
of locational advantages and, especially, created assets that a
country or region can offer potential investors.

Padma Mallampally was
until recently Senior
Transnational Corpora-
tions Affairs Expert,
UNCTAD, Geneva.

Karl P. Sauvant is Chief,
International Invest-
ment, Transnational,
and Technology Flows
Branch, Division on
Investment, Technology,
and Enterprise Devel-
opment, UNCTAD,
Geneva.

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