

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.

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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

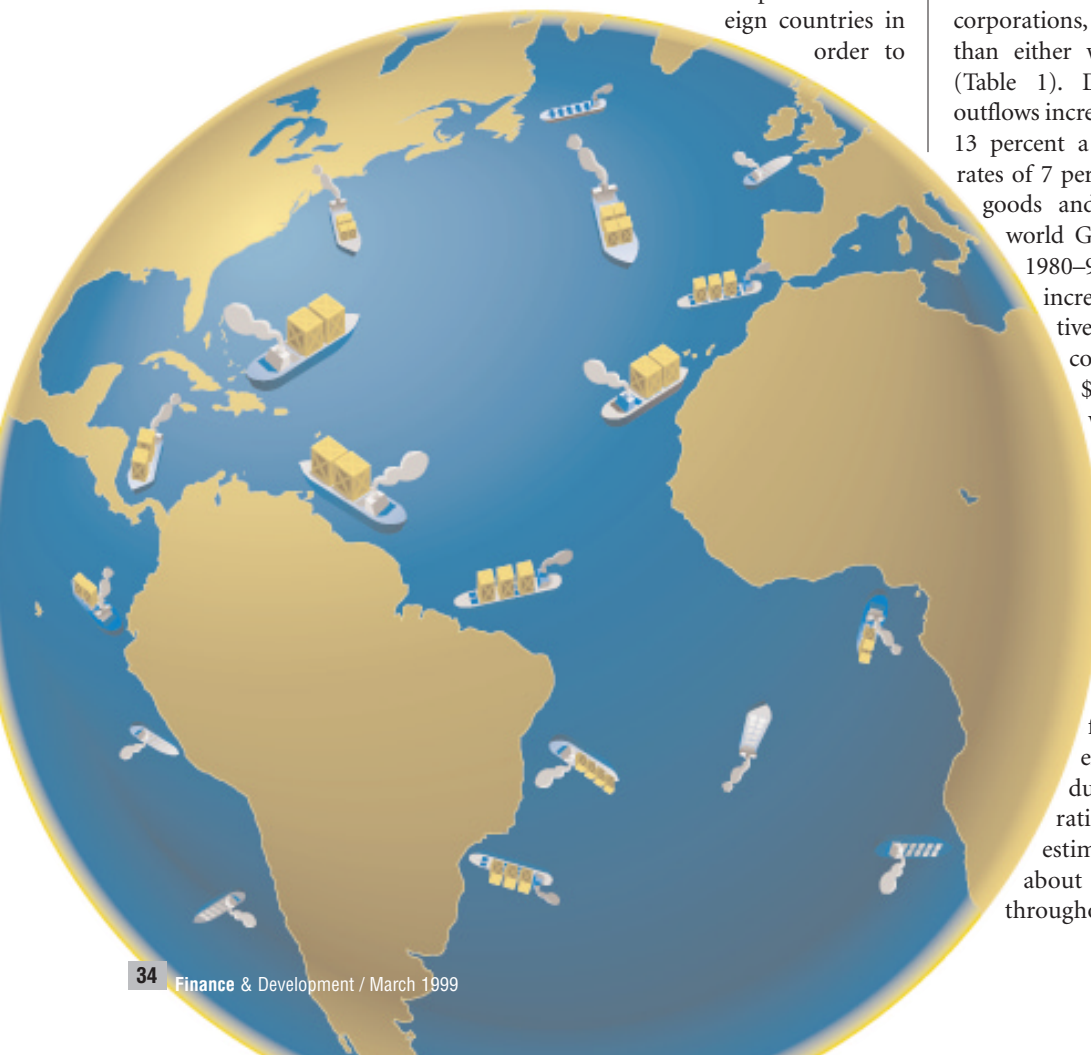


Table 1
Selected indicators of foreign direct investment (FDI) and international production, 1986–97

	Value at current prices (billion dollars)		Annual growth rate (percent)			
	1996	1997	1986–90	1991–95	1996	1997
FDI inflows	338	400	23.6	20.1	1.9	18.6
FDI outflows	333	424	27.1	15.1	-0.5	27.1
FDI inward stock	3,065	3,456	18.2	9.7	12.2	12.7
FDI outward stock	3,115	3,541	21.0	10.3	11.5	13.7
Cross-border mergers and acquisitions ¹	163	236	21.0 ²	30.2	15.5	45.2
Sales of foreign affiliates	8,851 ³	9,500 ³	16.3	13.4	6.0 ³	7.3 ³
Gross product of foreign affiliates	1,950 ³	2,100 ³	16.6	6.2	7.7 ³	7.7 ³
Total assets of foreign affiliates	11,156 ³	12,606 ³	18.3	24.4	12.0 ³	13.0 ³
<i>Memorandum:</i>						
GDP at factor cost	28,822	30,551 ⁴	12.1	5.5	0.8	6.0 ⁴
Gross fixed capital formation	5,136	5,393 ⁴	12.5	2.6	-0.1	5.0 ⁴
Royalties and fees receipts	53	61 ⁴	21.9	12.4	8.2	15.0 ⁴
Exports of goods and nonfactor services	6,245	6,432 ⁴	14.6	8.9	2.9	3.0 ⁴

Source: UNCTAD, *World Investment Report 1998: Trends and Determinants*, Table I.1, p. 2.

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.

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.

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



Table 2

Host country determinants of foreign direct investment (FDI)

Host country determinants	Type of FDI classified by motives of firms	Principal economic determinants in host countries
<p>Policy framework for FDI Economic, political, and social stability Rules regarding entry and operations Standards of treatment of foreign affiliates Policies on functioning and structure of markets (especially competition and policies governing mergers and acquisitions) International agreements on FDI Privatization policy Trade policy (tariffs and nontariff barriers) and coherence of FDI and trade policies Tax policy</p> <p>Economic determinants</p> <p>Business facilitation Investment promotion (including image-building and investment-generating activities and investment-facilitation services) Investment incentives Hassle costs (related to corruption and administrative efficiency) Social amenities (for example, bilingual schools, quality of life) After-investment services</p>	<p>Market-seeking</p> <p>Resource/asset-seeking</p> <p>Efficiency seeking</p>	<p>Market size and per capita income Market growth Access to regional and global markets Country-specific consumer preferences Structure of markets</p> <p>Raw materials Low-cost unskilled labor Skilled labor Technological, innovative, and other created assets (for example, brand names), including as embodied in individuals, firms, and clusters Physical infrastructure (ports, roads, power, telecommunications)</p> <p>Cost of resources and assets listed above, adjusted for labor productivity Other input costs, such as transport and communication costs to/from and within host economy and other intermediate products Membership of a regional integration agreement conducive to the establishment of regional corporate networks</p>

Source: UNCTAD, *World Investment Report 1998: Trends and Determinants*, Table IV.1, p. 91.

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 “hassle” costs of doing business. While by no means new, these measures have proliferated and are becoming more sophisticated, targeting individual investors and investments in particular industries. After-investment services are noteworthy because they can encourage reinvestment 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 determinants are in place.

Economic determinants. The most important determinants for the location of FDI are economic 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 services; 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 strategies to enhance their competitiveness.

Trade liberalization and FDI and technology flows, combined with deregulation and privatization, have not only improved firms’ access to markets for goods and services and to immobile factors of production but also increased competitive pressures in previously protected markets, forcing firms to seek new markets, resources, and assets abroad. At the same time, technological advances have enhanced firms’ ability to coordinate 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 competitiveness. 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 integration 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



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into specific activities or functions and performing 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 maintain a competitive edge. Created assets include communications infrastructure, marketing networks, 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 probably 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 activity, 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 economic development, all governments want to attract it. Indeed, the world market for such investment is highly competitive, and developing 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. **F&D**

This article draws extensively on United Nations Conference on Trade and Development (UNCTAD), World Investment Report 1998: Trends and Determinants (New York and Geneva: United Nations).