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Foreign direct investment in developing countries: What policymakers should not do and what economists don't know

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Foreign Direct Investment in Developing Countries

What Policymakers Should Not Do and What Economists Don't Know

by Peter Nunnenkamp

CONTENTS

- Since recent financial crises in Asia and Latin America, developing countries have been strongly advised to rely primarily on foreign direct investment (FDI) in order to promote economic development on a sustainable basis. Even harsh critics of rash capital account liberalization argue in favor of opening up towards FDI. Yet, economists know surprisingly little about the driving forces and the economic effects of FDI. There are few undisputed insights on which policymakers can rely.
- Globalization through FDI has become significantly more important since the early 1990s. Various groups of developing countries have participated to a strikingly different degree in the FDI boom. However, the distribution of FDI does not support the widely held view that FDI is concentrated in just a few developing countries. Considered in relative terms, various small and less advanced countries have been attractive to FDI.
- Policymakers should be aware that various measures intended to induce FDI, including the liberalization of FDI regulations and business facilitation, are unlikely to do the trick. Promotional efforts will help little 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 by giving rise to costly “bidding wars.”
- The importance of traditional determinants of FDI, notably the size of local markets, can no longer be taken for granted. Globalization tends to induce a shift from purely market-seeking FDI to new types of FDI, for which the international competitiveness of local production is highly relevant. The challenge for policymakers in developing countries then is to create immobile domestic assets that provide a competitive edge in the competition for FDI. This task has various dimensions, ranging from local capacity building and the provision of efficient business-related services to trade liberalization with regard to capital goods and intermediate products.
- Policymakers should not expect too much from FDI inflows. Capital formation continues to be a national phenomenon in the first place. FDI is superior to other types of capital inflows in some respects, particularly because of its risk-sharing properties, though 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.

Contents

I. Introduction	3
II. FDI Trends: Winners and Losers	3
III. FDI Determinants: What Matters for Developing Countries?	8
1. Overall Policy Framework: Diminishing Returns of FDI Liberalization?	10
2. Economic Factors: Traditional Determinants on the Decline?	11
3. Business Facilitation: Costly, but Not Effective?	13
IV. Growth Effects of FDI: Insufficiently Explored Territory	14
V. Summary and Conclusions	16
References	17

I. Introduction

Especially since recent financial crises in Asia and Latin America, developing and newly industrializing 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 liberalization dismiss the option of complete isolation from international capital markets and argue in favor 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 policymakers can 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 globalization. The economic effects of FDI do not allow for easy generalizations. Empirical studies on the growth impact of FDI have come up with conflicting results.

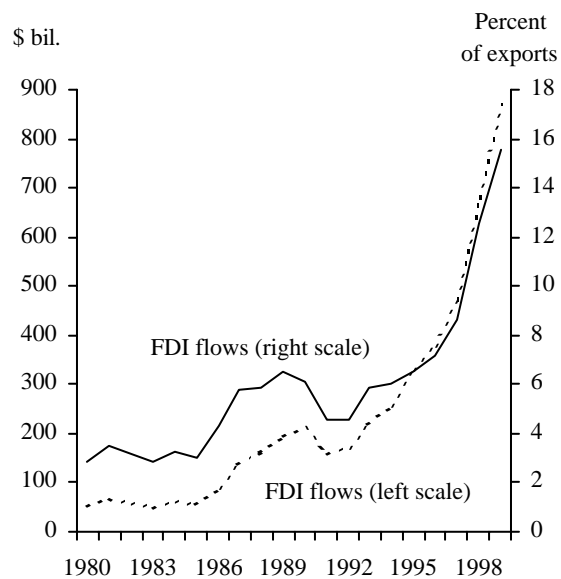
The subsequent stocktaking starts by portraying recent trends with regard to the growth and distribution of FDI (Section II). The discussion of FDI determinants in developing and newly industrializing countries focuses on factors that can be influenced by host country governments (Section III). Section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

¹ Borensztein et al. (1998) as well as UNCTAD (var. issues 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 worldwide FDI flows constitutes a major element of economic globalization. Annual FDI flows increased fifteen-fold from \$55 billion in 1980 to \$865 billion 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 worldwide 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 internationalization strategies, globalization through FDI has gained significantly in relative importance.

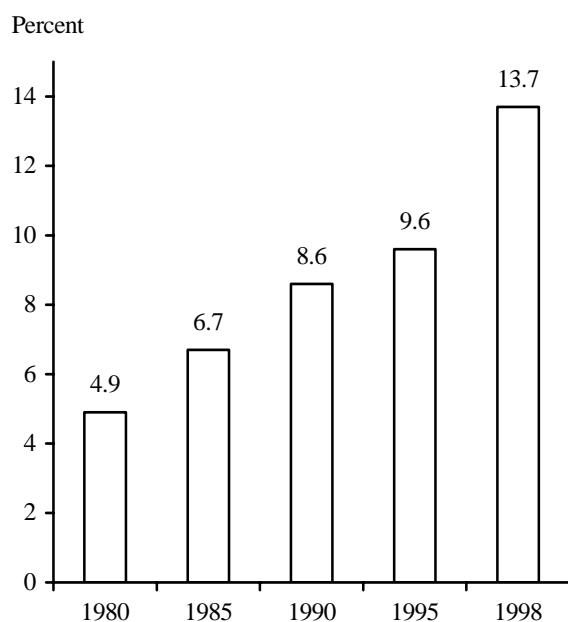
Figure 1: World FDI Flows, 1980–1999 (billions of dollars and percent of world exports)



Source: UNCTAD (var. issues); IMF (2000).

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 worldwide FDI *stocks* are related to world GDP (Figure 2). Furthermore, while booming FDI

Figure 2: Worldwide FDI Stocks^a, 1980–1998 (percent of GDP)



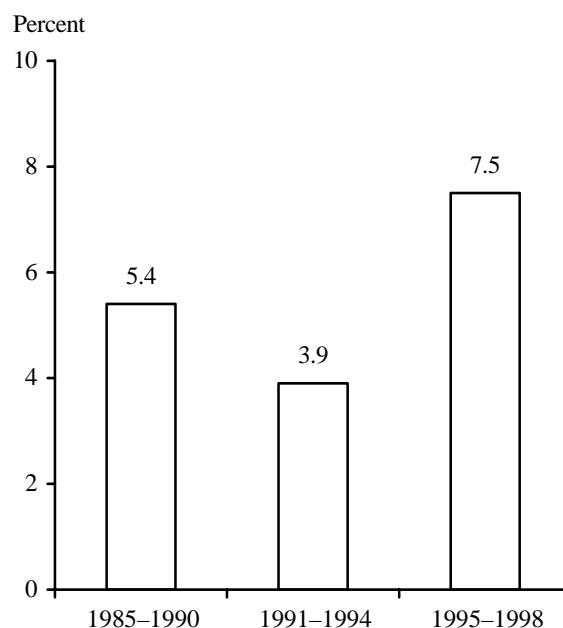
^aInward FDI stocks.

Source: UNCTAD (var. issues).

clearly points to increased international capital mobility, the contribution of FDI to gross fixed capital formation remained modest (Figure 3). Worldwide 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.

Traditionally, FDI was a phenomenon that primarily concerned highly developed economies. Developed countries still attract a higher share of worldwide 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 have attracted almost one third of worldwide FDI flows recently.

Figure 3: World FDI Inflows, 1985–1998^a (percent of gross fixed capital formation)



^aAnnual averages.

Source: UNCTAD (var. issues).

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 var. issues). 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 the FDI flows to all developing countries in the 1990s and left Latin America considerably behind in terms of attractiveness for FDI.

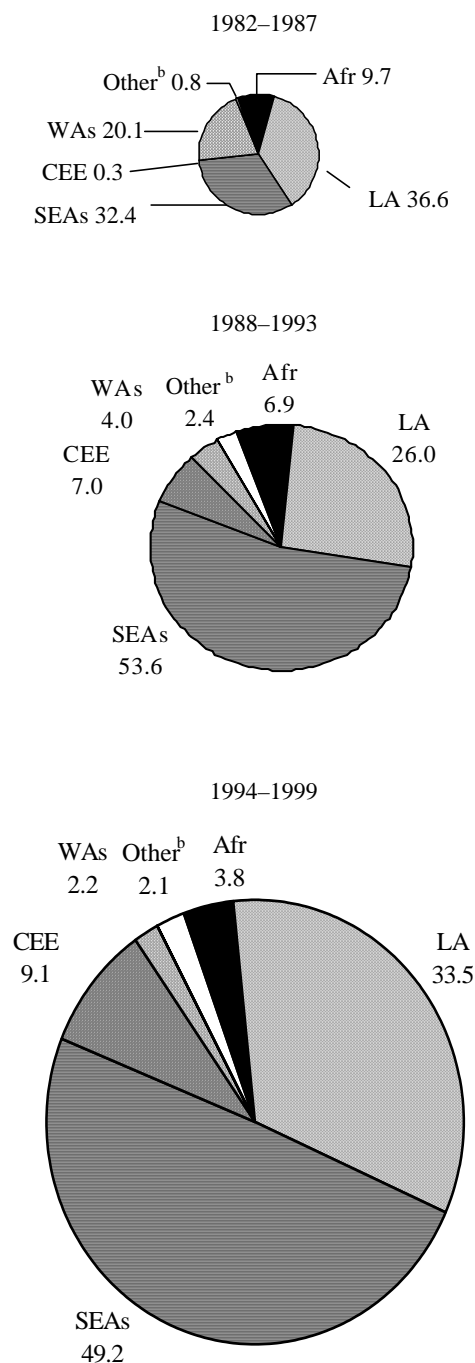
Figure 4: Share of All Developing Countries in Worldwide FDI Inflows, 1982–1999 (percent)



Source: UNCTAD (var. issues).

- 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.
- Apart from South, East and Southeast Asia, the second winner, in terms of FDI shares, is

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.

^aIncluding Central and Eastern Europe. – ^bDeveloping Europe, Central Asia, and Pacific.

Source: UNCTAD (var. issues).

Central and Eastern Europe. This development is obviously related to the demise of the socialist regimes 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 globalization 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 halved 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 develop-

ing economies (e.g. UNCTAD 1995; Collins 1998). This notion seems to imply that most developing countries do not have favorable prospects to attract FDI. However, this concern is largely unjustified as it is based on the distribution of FDI in absolute terms.

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.

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), Côte d'Ivoire (24.2), and Malawi (22.9) would enter the group of the 20 top performers. According to findings

² For a detailed discussion, see Nunnenkamp (2000a).

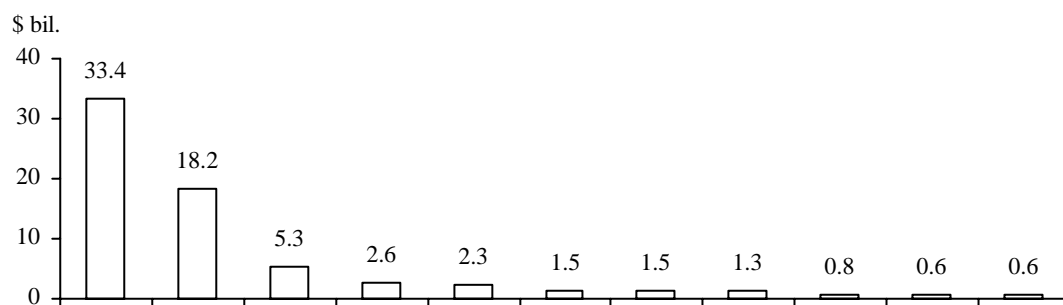
³ Note that the definition of West Asia in Figure 5 is according to UNCTAD's World Investment Report. This means that Turkey is included in West Asia, whereas Egypt is included in Africa. By contrast, Egypt is a member of the UN Economic and Social Commission for Western Asia (ESCWA), whereas Turkey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

Box: FDI Patterns in West Asia

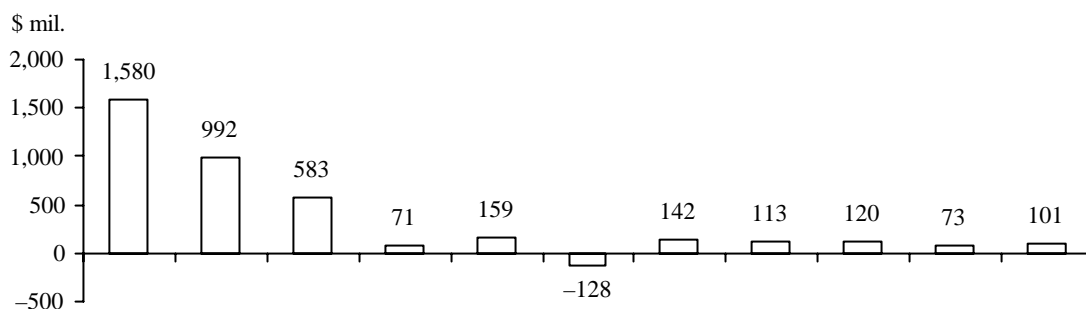
Just two members of the UN Economic and Social Commission for Western Asia (ESCWA), namely Egypt and Saudi Arabia, absorbed the bulk of FDI in this group of 13 countries. Egypt and Saudi Arabia accounted for more than three quarters of inward FDI stocks in ESCWA countries (upper panel of box figure).

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

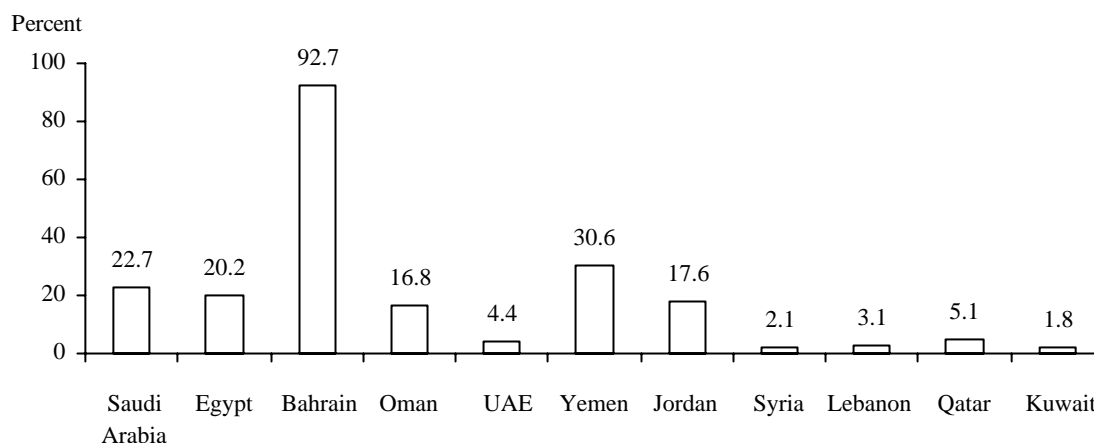
(a) Inward FDI stock, 1999



(b) Annual average FDI inflows, 1994–1999



(c) Inward FDI stock, 1998 (percent of GDP)



^aData for Palestine and Iraq not available.

Box to be continued

Box continued

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 \$27.4 billion 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 \$250 million in 1991 and an – estimated – maximum of \$1.5 billion 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 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 (var. issues 2000).

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.

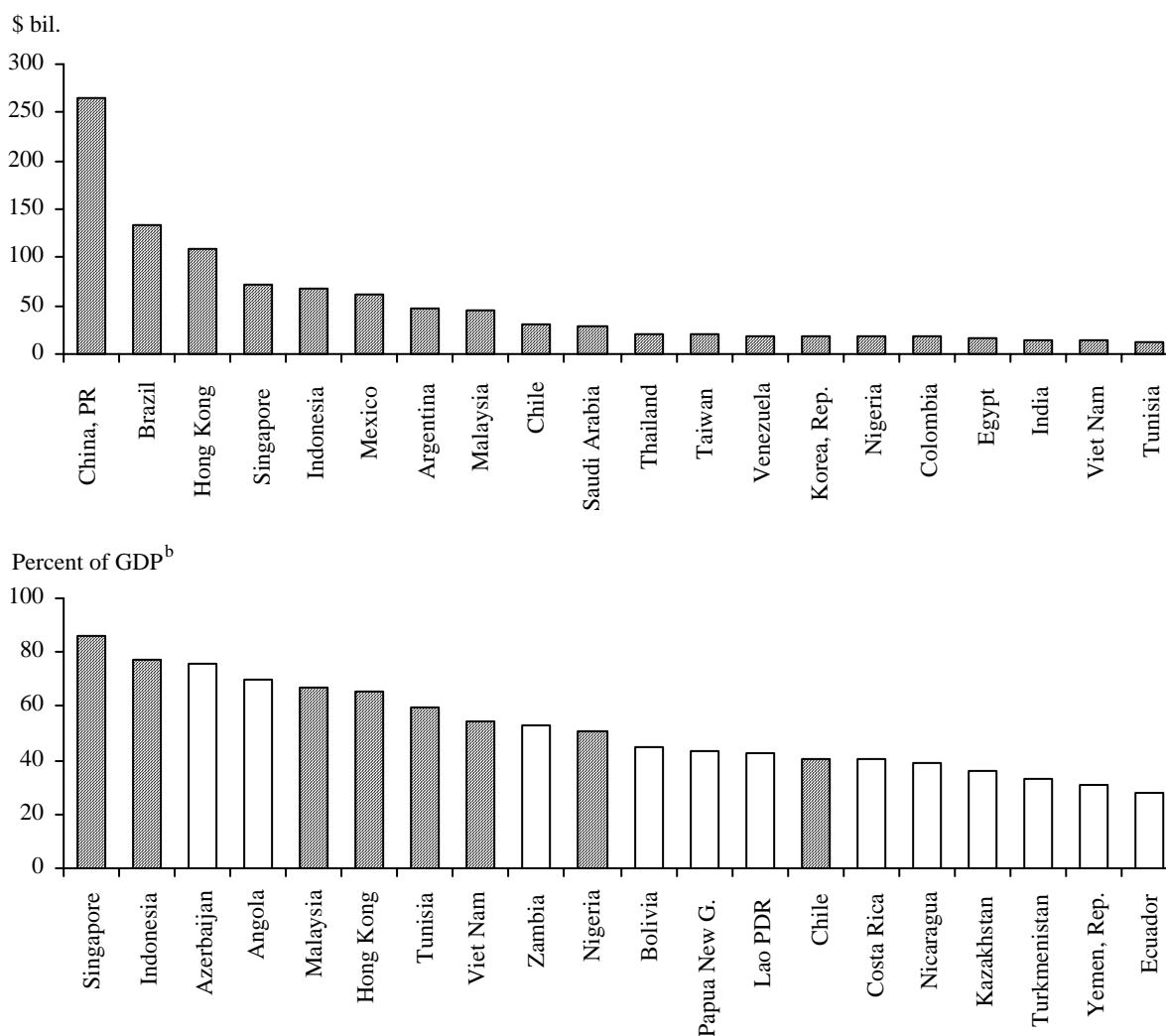
⁴ This remains true when FDI is considered in per capita terms, instead of relating FDI to GDP. For instance, the per-capita FDI stock in 1998 was higher in Costa Rica than in Brazil and Mexico. Angola proved more attractive by this measure than Egypt and Nigeria, and Papua New Guinea hosted a higher 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 host country governments cannot influence them.⁵ As noted before, our knowledge is fairly limited as concerns the *relative* importance of different location-specific

⁵ According to the widely known OLI (ownership, location, internalization) framework (Dunning 1993), firm-specific factors concern competitive advantages in a transnational 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).

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



^aExcluding Caribbean financial centers. – ^bExcluding developing countries with a population of 3 million and less. Countries with shaded bars belong to the 20 top performers in absolute terms.

Source: UNCTAD (var. issues 2000).

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 globalization. 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

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 (var. issues 1998: Chapter IV).

Figure 7: Selected Host Country Determinants of FDI

Overall Policy Framework		Business Facilitation	
→ economic and political stability		→ administrative procedures	
→ rules regarding entry and operations of TNCs		→ FDI promotion (e.g. facilitation services)	
→ bi- and multilateral agreements on FDI		→ FDI incentives (subsidies)	
→ privatization policy			
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 labor costs	
→ complementary factors of production (labor)	→ market growth	→ sufficiently skilled labor	
→ physical infrastructure	→ regional integration	→ business-related services	
		→ trade policy	
^a Differentiated by major motivations of FDI.			

Source: Adapted from UNCTAD (var. issues 1998: Table IV.1).

1. Overall Policy Framework: Diminishing Returns of FDI Liberalization?

The overall policy framework comprises quite heterogeneous elements, such as economic and political stability as well as regulations governing the entry and operations of transnational 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.

For example, the liberalization of national FDI frameworks has become the dominant type of FDI policy change in dozens of developing countries since the mid-1980s (UNCTAD var. issues 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 several of these liberalizing countries. TNCs tend to take more liberal FDI regimes for granted, and consider the

convergence of FDI regimes to be the natural consequence of globalization. As a result, the liberalization of FDI regulations may be characterized by diminishing returns. Developing countries not taking part in the general move towards liberalization 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 liberalization.

There may be one major exception to this line of reasoning among the factors listed in Figure 7 under "overall policy framework," namely privatization. While the trend towards privatizing state-owned enterprises is almost as broadly based in developing countries as the liberalization of FDI regulations, privatization 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

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

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

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

Yet, privatization-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 privatization. Second, privatization-related FDI may be problematic from a competition-policy point of view. In the 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, privatization should go along with trade liberalization and competition policies preventing the misuse of monopoly power and enhancing competition by breaking up monopolies. Third, privatization-related FDI is often believed to be a one-off event. This is not necessarily true, however. Privatization 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 rationalization and modernization of privatized firms. Reinvested earnings of firms which foreign investors acquired through privatization may lead to FDI flows beyond those associated with the initial transaction. Finally, privatization programs help improve the climate for FDI in indirect ways, e.g., by indicating the government’s commitment to economic reform. Hence, privatization-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.

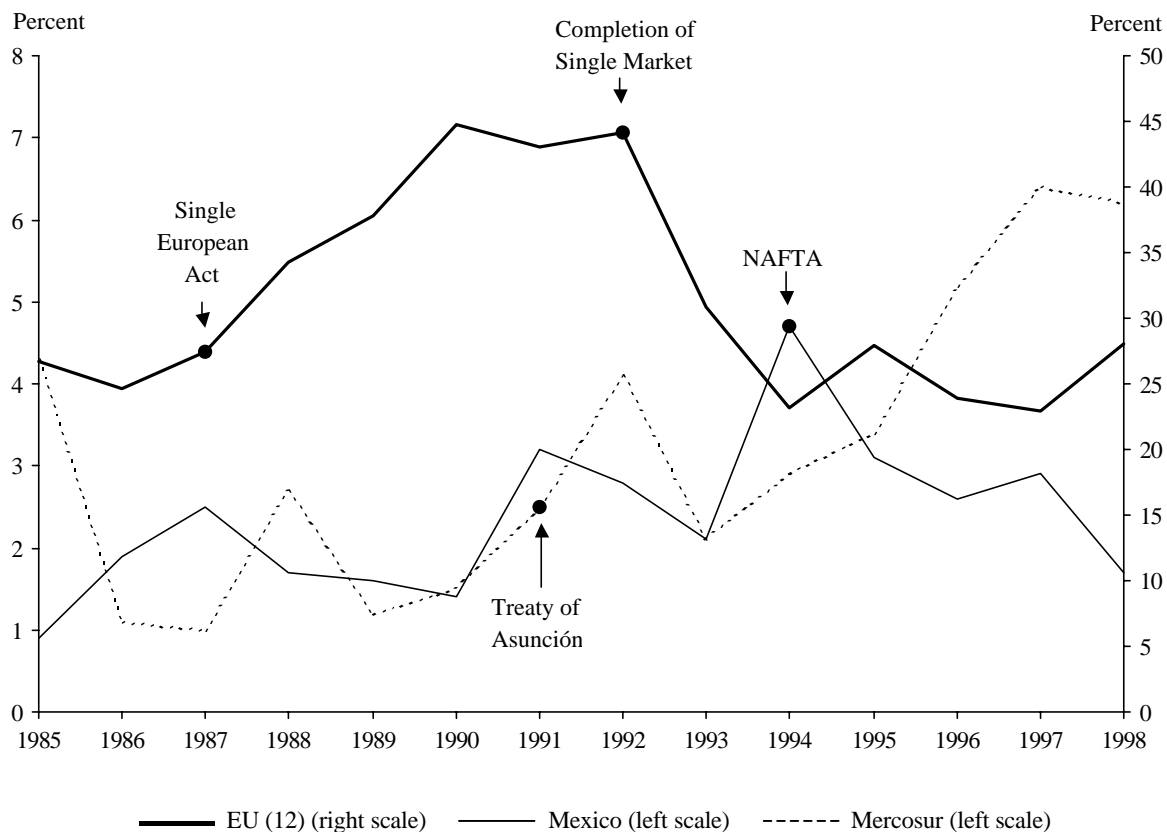
Resource-seeking FDI is motivated by the availability of natural resources in host countries. This type of FDI was historically fairly important and remains a relevant source of FDI for various developing countries. On a worldwide scale, however, the relative importance of resource-seeking FDI decreased 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 var. issues 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). 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 favored 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.

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 globalization. As concerns *past* 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

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

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



Source: World Bank (2000).

this is (and will be) still true with ongoing globalization.

Traditionally, FDI was the only reasonable means to penetrate local markets in various developing countries. For instance, exporting to Latin America was no 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 since recently. Many developing countries have liberalized their import regime, thereby enabling TNCs to choose between exporting and undertaking FDI. As a consequence, purely market-seeking FDI may decline. UNCTAD (var. issues 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 pos-

sible 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. Policymakers 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 is frequently referred to when looking for empirical

support to the reasoning that regional integration promotes FDI.

I have argued elsewhere that both 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 globalization 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 var. issues 1998: 253). By contrast, international competitiveness of local production, including local production by foreign investors, becomes the critical factor if globalization alters the form and purpose of FDI.

Globalization 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.

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 realize 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 labeled 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 the great majority of them tried to identify and attract foreign investors (UNCTAD var. issues 1998: 101).
- Investment-facilitation services consist of counseling, speeding up the approval process,

and assistance in obtaining permits. “One-stop shops” often provide these services.

- 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 proactive policies, given that FDI liberalization alone suffers from diminishing returns. However, there is a trend towards a convergence of policies and practices not only with regard to FDI liberalization 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 \$20,000 per job created in the early 1980s to more than \$200,000 in several instances in the 1990s. UNCTAD (var. issues 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 neighbors, e.g. governments in the same region. This may render it fairly difficult to strengthen cooperation 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 realize 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 policymaking is particularly wide. Policymakers 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 policymakers 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 cooperative approach may help prevent costly “bidding wars,” but the difficulties in orchestrating and enforcing effective cooperation among competitors should not be underestimated, not least because cooperation must involve local authorities in addition to national governments. The real test comes when investors start playing governments off against each other 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.

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

¹⁰ For a survey, see Pirnia (1996).

host countries than other types of capital inflows. Especially after 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:

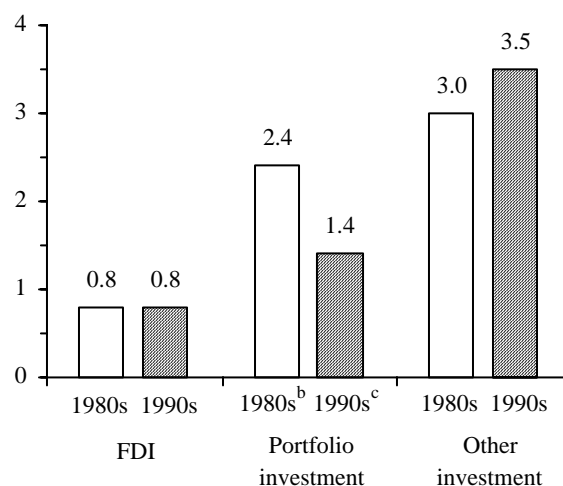
- In contrast to foreign lenders and portfolio investors, foreign direct investors typically have a longer-term perspective when engaging in a host country. Hence, FDI inflows are less volatile and easier to sustain at times of crisis.
- While debt inflows may finance consumption rather than investment 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. In addition, 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.

The former chief economist of the Inter-American Development Bank, Ricardo Hausmann, has objected 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

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



^aStandard deviation divided by mean. Average of country-specific coefficients of variation (absolute value) for 13 Asian and Latin American countries (annual data). – ^bWithout Chile, Mexico, Peru, and Venezuela. – ^c1.3 without countries listed in note b.

Source: IMF (2000).

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 as 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 analyzed

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 summarized 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 (var. issues 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 labor 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 robust positive correlation with growth. By contrast, debt-related inflows are negatively correlated with the growth rate in economies with undercapitalized 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 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 globalization went along with booming FDI in developing countries, which attracted a rising share of worldwide 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, policymakers 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 liberalization of FDI regulations and various business facilitation measures. Other reforms, such as

privatization, 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.

Globalization 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 policymakers 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: liberalizing 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. Policymakers should not ignore the – direct and indirect – costs of discretionary FDI incentives.

Finally, policymakers 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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