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Research Report

Is foreign direct investment losing clout in development

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Briefing Paper 2/2022

Is Foreign Direct Investment Losing Clout in Development?

Over the last decade, only a single projection of foreign direct investment (FDI) flows by the United Nations influential "World Investment Report" has proposed a negative outlook in the medium term. Based partly on surveys of business executives, these forecasts reflect expectations of investment growth which, however, have repeatedly failed to materialise. In fact, FDI flows to developing countries have remained stagnant over the past decade.

Such wishful thinking is nurtured by a long series of positive narratives and facts about foreign investment. FDI has been one of the pillars of international development efforts for over 70 years. Its promise has not been limited to critical finance, but extends to longer term competitiveness through access to better technology, managerial know-how and, above all, prosperity through more and better paid jobs in the formal sector. From the old prescriptions of the so-called Washington Consensus to the hopeful Addis Ababa Action Agenda, the dominant development narrative has therefore favoured a rather indiscriminate pursuit of investment volume.

This brief calls for rethinking of narratives and policies that help to improve the impact of FDI, based on secular trends that challenge our expectations. Four such trends stand out:

First, while other sources of finance for development have grown considerably over the last decades, foreign investment has not followed the trend. Second, the kind of investment that is associated with stronger gains and longer term commitment in host economies – greenfield FDI – has also been in consistent decline as a share of total investment, while mergers and acquisitions and project finance have gained in importance. Third, the top 100 multinational enterprises (MNEs), accounting for nearly a quarter of global FDI stock, rely less on employment today than they used to in order to grow their foreign presence. Job creation, knowledge transfer and spillovers are therefore less likely to materialise through the presence of mega-firms and their corresponding investment at scale. Fourth, the growth of Chinese outward FDI within a strategic expansionary political agenda stands to change rules and attitudes towards foreign investment moving forwards.

We argue that, collectively, these trends invite a renewed conversation around the kind of foreign investment we want and expectations of this source of finance for development. These facts obscure neither the broad benefits of FDI to developing countries, nor the value proposition of FDI attraction. Rather, they raise questions about expectations, priorities and the alignment of investment policy with the realities experienced across developing countries.

To that end, we propose four priorities that stand to make a difference in the current context. We call for policy-makers to:

1) Place additional emphasis on retention of investment and linkages with the domestic economy.

2) Try new approaches for FDI attraction that focus on improving domestic investment facilitation frameworks.

3) Be selective as to investment sources and activities in order to mitigate political risks and align inward investment better with sustainable development.

4) Add evidence to improve our understanding of investment and inform decision-making.

Overall, it is critical to engage in a serious multi-stakeholder conversation around expectations, actors and solutions that respond to the investment reality of today.

FDI shrinks as a share of total development finance and external source of finance

Falling short of the ambition set out in the Addis Ababa Action Agenda in 2015, external sources of development finance have stagnated since the global financial crisis of 2008/2009. While remittances and multilateral development finance have grown during that period, the surplus mostly covered loses in other sources of external finance, and in particular FDI.

Foreign investment used to be the dominant source of external development finance. Having peaked at over 60 per cent of external flows to developing countries in 2007, the share of FDI was in consistent decline through the 2010s, falling to nearly 45 per cent at the onset of the COVID-19 pandemic in 2020 (Figure 1).

The Sustainable Development Goals, as part of the 2030 Agenda for Sustainable Development, will require some USD 3.7 trillion annually to reach their targets in developing countries, according to the latest estimates by the Organisation for Economic Co-operation and Development (OECD). That gap looks increasingly unlikely to be filled with foreign investment.

The most beneficial FDI flows are increasingly rare

Not all FDI has the same development impact. Greenfield investment (i.e. the creation of new production facilities in host economies) generally translates into benefits that are particularly sought after in developing countries: new and on average better paid jobs in the formal sector, capital formation, and technology and managerial expertise that has previously been unavailable, in addition to a longer term commitment of presence.

Yet over the last two decades, that kind of foreign investment has represented an increasingly smaller share of the pie. At the turn of the century, announcements of new greenfield projects exceeded total FDI flows by a large margin. This pattern reflected a positive growth outlook, as well as a more interconnected world economy. At the onset of the pandemic, 20 years later, the volume of greenfield investments had shrunk in relative terms to half of total investment flows (Figure 2). Part of the decline can be attributed to a less positive outlook, and part to the rise of other forms of entry, such as firm acquisitions or international project finance.

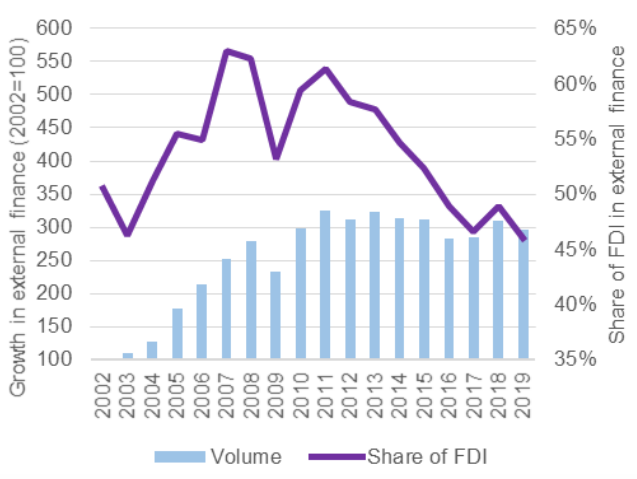
The drivers and impact in different contexts of brownfield investment (i.e. the entry into a foreign market by investing in an existing company) remain less well understood in policy discussions. While its development impact is generally thought to be lower than greenfield investment, evidence has shown that it can be significant in the medium term, which invites a re-assessment of incentives and framework conditions to foster its potential (World Bank, 2020).

The top 100 MNEs rely less on foreign employment to grow their foreign presence

FDI is granular. The foreign assets of only 100 mega-firms accounted for nearly a quarter of global FDI stock in 2020, exceeding USD 9 trillion. These firms and the network of suppliers they bring along are major drivers of investment trends and impact, making developing countries crave their attention. The sheer number of jobs created by Intel's presence in Costa Rica, or Samsung's in Vietnam are only two highly visible illustrations of the effect of such investments, which can change a country's development path.

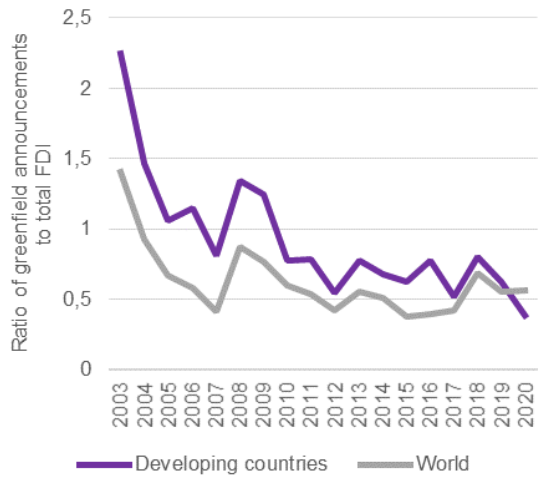
The top 100 MNEs have doubled their foreign sales since 2005 and grown their foreign assets by even more. Their job creation, however, has not kept up with that pace (Figure 3). Their increase in foreign sales was achieved without a commensurate growth of foreign employment, highlighting their ability to reach foreign markets without the corresponding tangible investment. Digital MNEs – comprising anything from internet platforms to firms specialising in ecommerce or digital solutions and content – are increasing their presence in

Figure 1: FDI and external development finance growth (2002=100) in absolute and relative terms



Source: Authors' calculations based on historical extracts from the OECD Transition Finance Dashboard (Financing Mix).

Figure 2: Value of announced greenfield investments relative to FDI inward flows



Source: Authors' calculations based on United Nations Conference on Trade and Development (UNCTAD) World Investment Reports (2003-2020).

the top 100, according to the latest World Investment Report (UNCTAD, 2021), which reinforces the patterns described above.

Moving forward, job creation, knowledge transfer and spill-overs associated with foreign presence are less likely to materialise through mega-investments from large firms. These trends reflect the broader effects of digitalisation and market concentration that affect the impact MNEs can have in developing countries.

China is increasingly dominating international investment flows, diluting economic motivations with strategic ones

The growth of Chinese outward FDI over the past 15 years has been one of the most important features of the world economy. With a volume of foreign investment flows exceeding both the United States and Japan for the first time in 2020, China now ranks at the top globally as the biggest foreign direct investor (Figure 4) even at moderately declining levels of outflows.

The Chinese government has supported outward FDI since 2006, when it announced its "Going Out" strategy. For China, outward FDI promotion has not only often been seen as an instrument of industrial policy at home, but also a pillar of strategic foreign policy, with evidence of active government involvement (Stone et al., 2022).

China's Belt and Road Initiative (BRI) is a prime example of the kind of strategic foreign policy choice – incorporated as of 2017 in the Constitution of the Communist Party of China – to which outward FDI subscribes. While the BRI has the potential to improve partner countries' access to financing in Eurasia and Africa, in particular in the infrastructure sector, it is often part of a package of agreements at multiple levels of government that lack transparency (World Bank, 2019).

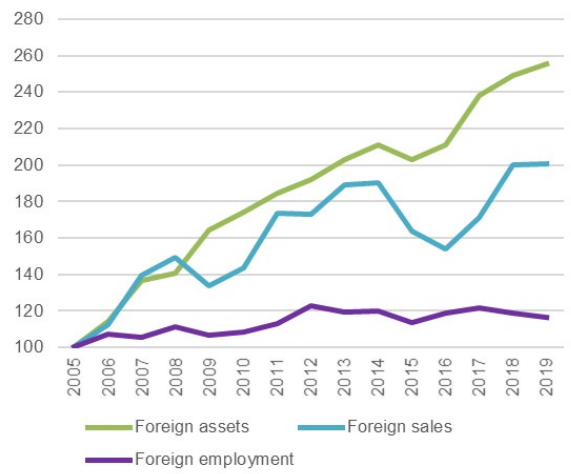
For these reasons and compounded by worsening socio-economic conditions globally, Chinese outward FDI has been facing an increasingly hostile policy environment in other industrialised economies. The number of Chinese investment projects challenged by host countries doubled from 86 projects in 2010-2014 to 174 in 2015-2020 (Evenett & Fritz, 2021). An increasing number of governments take measures to safeguard against the involvement of the Chinese state by setting up or strengthening investment screening mechanisms. Yet not all economies have the luxury or the institutional will to be selective. The rising geo-economic tensions with China carry the prospect of longer term impact on the global FDI policy regime – normalising barriers, screenings and conditions that were in the past considered suboptimal. This trend invites a broader discussion on the kind of FDI that developing countries need, the longer term risks and safeguards to protect sustainable benefits from investment.

What now for policy?

FDI has not been fulfilling the – perhaps exuberant in the current context – expectations placed in it as a driver of global development. We observe secular setbacks in terms of volume, entry modes, impact and foreign policy interference that call for a reassessment of both the narratives about FDI and the policy frameworks that support it. We propose four priorities that aim to better align investment policy with the realities experienced across developing countries:

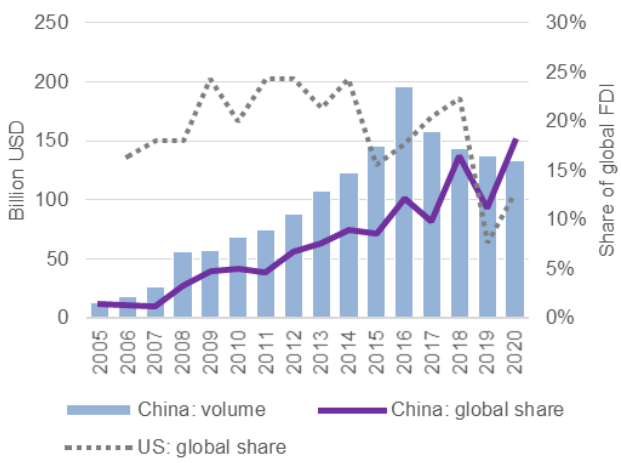
1) *Place additional emphasis on retention of investment and linkages with the domestic economy*. While FDI flows have been stagnating, FDI stocks are still at an all-time high of over USD 40 trillion globally. As new investment becomes harder to attract, policy-makers should therefore emphasise retaining and expanding existing investment. Best practices to that end include broad packages of so-called "aftercare services"

Figure 3: Foreign sales, assets and employment of top 100 MNEs (2005=100)



Source: Authors' calculations based on UNCTAD, World Investment Reports 2005-2020.
Note: Values of foreign assets and sales of the top 100 MNEs have been deflated using the OECD Structural Analysis (STAN) database before being expressed in relative terms.

Figure 4: Outward FDI from China



Source: Authors' calculations based on UNCTAD, World Investment Reports 2005-2020.

by investment promotion agencies, such as through operational and administrative assistance for investors, or the establishment of mechanisms to detect and solve frictions between investors and governmental agencies at an early stage.

Long-term commitment and expansion of foreign ventures requires linkages with the host economy, which can materialise through a range of initiatives, such as matchmaking between multinationals and domestic suppliers and support for upgrading the capabilities of local companies in their value chains. A focus on domestic capabilities works in multiple ways; for example, it helps to improve the development impact of existing foreign investment and the prospects of attracting new investors in the future that want to benefit from a more competitive domestic supplier base. These improvements will also generate additional revenues that enhance governments' ability to finance development. By upgrading infrastructure, worker skills and local suppliers, and fostering linkages to MNEs, all three objectives – of attracting, expanding and enhancing the impact of investment – are duly served. The scarce resources of host economies, as well as donor funds, can be used to build the institutional capacities supporting these initiatives.

2) *Try new approaches for FDI attraction*. For a long time, tax incentives and international investment agreements, providing foreign investors with legal protection and access to international arbitration, have been the main instruments to attract FDI – with limited success, as empirical research has shown. A more holistic approach that focuses on investment facilitation is now under negotiation in multilateral, regional and bilateral fora. Investment facilitation emphasises the transparency of local frameworks, the efficiency and predictability of administrative and legal processes surrounding investment and better coordination of key stakeholders (Berger & Sauvant, 2021). This agenda has the potential to accommodate a wide range of investor motivations and modes of entry, while preserving the domestic policy space that is vital to align investment with sustainable development objectives.

3) *Be selective as to investment sources and activities*. An indiscriminate focus on investment volume is increasingly futile in the face of a stagnating FDI flows, weaker development impact and longer term political risks. Higher income economies are increasingly selective in their approaches to investment sources (e.g. from foreign quasi-state entities) and activities (e.g. in highly polluting sectors), in order to mitigate political risks and align inward investment better with sustainable development. This approach reflects caution that is relevant to developing economies too. Taking a selective approach to investment, ultimately based on collectively defining features of the so-called "quality FDI", has the potential to create a new generation of investment policy.

4) *Add evidence to improve our understanding of investment and inform decision-making*. The rise of brownfield FDI and project finance, growing digitalisation and complex forms of organising production across borders requires new evidence to improve our understanding of the development impact of foreign investments. To enable evidence-based policy solutions it is essential to invest in statistical capacity and data collection at the level of firms, including reliable and comparable indicators of employment, innovation, carbon footprint and other dimensions of impact. Data on the activities of MNEs currently fail to support that objective.

Overall, it is critical to engage in a serious multi-stakeholder conversation around expectations, actors and solutions that respond to the investment reality of today. This conversation needs to take place between the traditional and new FDI home countries – involving also business, labour, civil society and academia – to initiate a reassessment of the narrative and advance new frameworks for investment that work for development.

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