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## EC 92 and its effect on foreign direct investment in developing countries

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EC 92 and Its Effect on Foreign Direct  
Investment in Developing Countries

by

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**EC 92 and Its Effect on Foreign Direct Investment  
in Developing Countries**

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## EC 92 and Its Effect on Foreign Direct Investment in Developing Countries\*

### I. Introduction

Ever since the European Community announced in the mid-1980s its programme to complete the internal market in 1992 [COM, 1985], fears have been raised that developing countries will tend to suffer from this development. This is mainly because of an apprehended diversion of trade and investment from the nonmember to the member countries. Greece, Portugal and Spain are comparatively less developed members of the Community and compete in several fields of trade and as hosts of foreign direct investment (FDI) with developing countries. After 1992, access to the Community's goods and capital markets will be completely free for the former countries but not to the latter. Therefore developing countries are concerned that international investors looking for relatively cheaper locational sites, who would have normally gone to developing countries, might invest in these three EC countries where wages, land for factory sites, costs of environmental protection and infrastructure are still relatively low and the goods produced with these investments shall have free access to the entire EC market. In addition to these advantages, proximity of markets will involve lower transport costs, quicker and reliable deliveries than is possible from developing countries of the other continents.

A similar but more recent concern of the developing countries refers to the North American Free Trade Area (NAFTA) consisting of the USA, Canada and Mexico. Mexico is situated next to the USA which is the biggest home country for FDI in developing countries. Some of the US investors may prefer to increase their FDI or start new investments in Mexico instead

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of investing in other developing countries which cannot offer the same preferential access as Mexico to the US market. This is, of course, one of the major incentives for Mexico to enter into such an alliance with its developed neighbours and open its market for competition from these countries.

This paper discusses at first how far the above apprehensions of developing countries regarding investment diversion are theoretically justified. Then empirical evidence is presented. Since NAFTA is at present in a nascent stage, the empirical discussion is confined to the European Community. The initiative for the completion of the internal market was taken in the middle of the 1980s [COM, 1985]. Since then the investors could easily anticipate that the Community was heading towards free mobility of goods and factors of production between its member countries, even if the final shape of EC 92 was not quite discernible at that stage. Since investment decisions are based on such anticipations, the data on FDI since 1985 should be able to demonstrate the effect of EC 92 on FDI flows to developing countries [Gittleman, 1990].

## **II. A Theoretical Discussion**

The basic question is how far a completion, extension or formation of a common market or free trade area such as EC 92 or NAFTA can divert FDI from developing to the member countries. In order to answer this it is appropriate to divide FDI into two categories. The first category includes those FDI which are not likely to be affected by the EC 92 on purely theoretical grounds. The second category deals with types of FDI which may be diverted to the member countries. This division is guided by the motives of investors which they follow while investing abroad. However, the statistical data on FDI are available only according to broad economic sectors and not according to investment motives. Therefore, the following discussion is based more on a division according to sectors than according to motives of FDI. This will facilitate the comparison between the theoretical discussion and the actual data available on FDI.

## 1. Investments Unlikely to be Affected by EC 92

The most obvious type of FDI which will not be diverted from developing to the member countries of the EC consists of investments in natural resources, especially petroleum, mining, and quarrying. Foreigners invest in these sectors usually for export. But depending on demand, the output can be sold also on local markets of host countries. Historically, natural resources were the initial attraction for private foreign investors in developing countries. They continued to be the main determinant of the inflow of foreign capital through the nineteenth to the early twentieth century. Later the primary sector lost some of its share to the manufacturing sector [Agarwal, 1979].

Another sector in which FDI would remain unaffected from the completion of the EC internal market consists of branches such as construction, real estate, trade, transport, storage, communication, finance, insurance, and other services. In most of the tertiary sector developing countries do not compete for investible funds with Spain or any other EC country. An investor looking for investment opportunities in local construction business in India, Malaysia or Thailand will not shift to Greece, Portugal or Spain because of an envisaged greater factor or goods mobility within the Community. The same applies to most of the other branches of the tertiary sector mentioned above. As in natural resources, investments in services are generally location specific.<sup>1</sup> Their mobility between two likely host countries is rather limited unless they are geographically situated so near to each other that the servicing of customers in each of them from any location does not raise problems and costs. This is not the case with the EC Mediterranean members on the one hand and the developing countries on the other hand. They are not only geographically far from each other but also the movement of capital, people, goods, and services between them is mostly restricted. Even if

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<sup>1</sup> Kravis and Lipsey [1988, p. 2] maintained that services are defined by the fact that production and consumption take place simultaneously within one country with only a few exceptions.

the freedom of movement existed, which is to some extent the case with the associated developing countries, a German bank or tourist agency, for example, will not substitute a subsidiary in Kenya with one in Greece or Portugal. Thus, the locational competition between the two groups of countries for FDI in the services sector is very weak or non-existent.

The primary and tertiary sectors together attract a very high share of FDI in developing countries. Two thirds of the total FDI of their biggest investor, viz. USA, are in these sectors [Scholl et al., 1992]. In the majority of the Asian countries, for which the sectoral data are readily available, these two sectors attracted more than half of the total FDI (Table 1). The primary sector alone accounted for four fifths of the foreign investments in Indonesia during the 1980s. Nepal, Papua New Guinea, the Solomon Islands, and Viet Nam are countries with one half to three fourths of total FDI in their primary sectors.<sup>2</sup> The domestic markets of these countries are relatively small to attract large amounts of equity capital in the manufacturing sector. In Bangladesh, Malaysia, and the Philippines, about one fourth of the FDI-stock is in the primary sector. New investments in the 1980s were more concentrated in their other branches.<sup>3</sup> In the two countries with the biggest domestic markets in this area, viz. China and India, the share of the primary sector in FDI is low and further declining. Here the developments in domestic markets appear more important for the inflow of FDI than changes in external environment such as the EC 92 programme.

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<sup>2</sup> In these countries, the inflow of foreign capital began not very long ago. As said already, in the early phases, FDI generally flows into primary sector of developing countries.

<sup>3</sup> These three countries together with Hong Kong, Pakistan, Singapore, Sri Lanka, South Korea, Taiwan, and Thailand, where foreign firms have invested to produce goods for exports also, are more interesting to examine a possible adverse impact of EC 92 on the inflow of FDI (see Section II.2.).



Table 1 -Sectoral Distribution of FDI in Asian Countries (per cent)

|   | Primary Sector    |               | Manufacturing Sector |               | Services and Construction |               |
|---|-------------------|---------------|----------------------|---------------|---------------------------|---------------|
|   | Inflow<br>1986-89 | Stock<br>1989 | Inflow<br>1986-89    | Stock<br>1989 | Inflow<br>1986-89         | Stock<br>1989 |
| Bangladesh (a,b)  | 0.4               | 25.1          | 33.2                 | 34.3          | 66.3                      | 40.7          |
| China (a,b)   | 4.5               | 13.3          | 52.9                 | 47.6          | 42.2                      | 40.1          |
| Fiji  | 7.8               | ...           | 29.5                 | ...           | 62.7                      | ...           |
| Hong Kong   | -                 | -             | 17.4                 | 25.9          | 82.6(c)                   | 74.1(c)       |
| India (d,e)   | 0.6               | 6.1           | 92.1                 | 89.1          | 7.2                       | 4.8           |
| Indonesia (f,g)   | 82.5              | 81.7          | 13.7                 | 15.4          | 3.8                       | 2.9           |
| Malaysia (a,b)  | 11.4              | 28.3          | 76.4                 | 41.2          | 12.2                      | 30.5          |
| Nepal (a,b)   | 20.6              | 49.9          | 54.0                 | 37.2          | 25.4                      | 12.9          |
| Pakistan (a,b)  | 13.7              | 11.5          | 23.7                 | 38.7          | 62.6                      | 49.8          |
| Papua New Guinea  | 41.8              | 60.2          | 8.6                  | 10.9          | 49.7                      | 28.9          |
| Philippines   | 27.9              | 29.3          | 45.7                 | 48.9          | 26.4                      | 21.8          |
| Rep.of Korea (a,b)  | 0.9               | 0.9           | 57.7                 | 61.5          | 41.5                      | 37.6          |
| Samoa (b)   | 15.9              | ...           | 27.3                 | ...           | 56.8                      | ...           |
| Singapore   | 0.2               | 0.2           | 35.7                 | 42.4          | 64.1                      | 57.4          |
| Solomon Islands   | ...               | 76.3          | ...                  | 1.5           | ...                       | 22.2          |
| Sri Lanka (a,b)   | 23.8              | 10.0          | 23.5                 | 32.5          | 52.7                      | 57.5          |
| Taiwan (f,e)  | 0.3               | -             | 65.7                 | 88.3          | 34.0                      | 11.7          |
| Thailand  | 3.2               | 9.2           | 49.0                 | 42.8          | 47.8                      | 48.0          |
| Viet Nam  | 67.7(h)           | 67.7          | 12.7(h)              | 12.7          | 19.6(h)                   | 19.6          |
| (a)1985-88. - (b)1988. - (c)The share of services and construction has been obtained by deducting the manufacturing share from the total FDI. - (d)1983-86. - (e)1986. - (f)1987-90. - (g)1990. - (h)1988-89. |                   |               |                      |               |                           |               |

Source: UNCTC, World Investment Directory 1992. Foreign Direct Investment, Legal Framework and Corporate Data. Vol. 1, Asia and the Pacific. New York 1992.

The data in Table 1 include FDI in agriculture, which absorbs in some cases nearly half or more of the foreign capital invested in the primary sector [UNCTC, 1992a]. This applies to Bangladesh, Fiji, India, Malaysia, Papua New Guinea, South Korea, the Solomon Islands, and Sri Lanka. It would be interesting to examine whether there are agricultural products in which these countries compete for FDI with the Mediterranean member countries of the EC. Only if there are such products, a case can be made for investment diversion from the former to the latter. This is more likely in the case of Latin American than Asian countries. FDI in the agricultural sector of Asian countries is mostly in products such as tea (India, Sri Lanka), rubber (Malaysia), and forest timber (Fiji). In these cases,

the locational choice of the investors is country specific and cannot be shifted to the Southern members of the Community.

Most of the Asian countries had a high proportion of FDI in tertiary sector also (Table 1). More than half of the foreign investments in Bangladesh, Fiji, Hong Kong, Pakistan, Samoa, Singapore, the Solomon Islands, and Sri Lanka was in services and construction. In China, Papua New Guinea, South Korea, and Thailand these investments accounted for two fifths to one half of the total inflows during the second half of the 1980s. The increased inflow of capital in this sector is, of course, a result of liberalization and deregulation measures in these countries. But relatively high shares in FDI stocks indicate that even earlier this sector was very attractive for foreign investors. FDI in this sector will remain largely unaffected by the completion of EC internal market.

FDI in the manufacturing sector will remain unaffected by the EC 92 provisions to the extent it is undertaken to supply the domestic market of developing countries. Such investment is lured by market size and growth, advantages of direct presence in the vicinity of customers, discriminatory government procurement policies, and savings in transport costs which would otherwise occur in supplying the same market through exports. None of these variables in developing countries change as a direct consequence of EC 92. Therefore, the domestic market oriented FDI should not be negatively affected by EC 92.

The domestic market of the host countries (proxied by national income and its growth) has been found as the most important determinant of FDI in the Third World by the empirical studies based on cross-country data.<sup>4</sup> This applies certainly to countries with relatively large domestic markets and favourable growth prospects. In Asia, India, China and Indonesia have relatively large domestic markets. High growth rates and increased income levels in South Korea, Malaysia and Thailand have raised the domestic demand potential in recent years so that they attract FDI not only in consumer goods but also in

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<sup>4</sup> For a survey of relevant studies see, Agarwal [1980], UNCTC [1992a]. For FDI from the USA, West Germany and Sweden see Dunning [1980], Agarwal et al. [1991] and Swedenborg [1979], respectively.

intermediate goods industries. In Latin America, Argentina and Brazil have large domestic markets, but the record of income growth in the 1980s has been poor. Hong Kong and Singapore are two classical locations where foreign investors have been producing goods for foreign markets and not as much for local customers. As it is argued below, EC 92 may, at least theoretically, affect strongly export-oriented FDI in such countries which compete for FDI with other low cost economies within the Community.

## **2. Investments Likely to be Affected by EC 92**

In the past three decades many multinational firms shifted some of their manufacturing activities to developing countries to take advantage of comparatively low unit costs of labour or other factors of production such as land. Among the commonly known examples of these investments are those of European textile firms in Northern Africa, American consumer electronic firms in the Northern Belt of Mexico, and Japanese textile and consumer goods firms in neighbouring Pacific-Rim countries. Such investments have contributed significantly to the growth of free trade zones in many host countries. In so far as this FDI is export-oriented, it may be affected by EC 92 because the goods produced in the Southern member countries of the Community will not face any entry barrier in other member countries whereas the goods produced in developing countries will, if they have no equivalent preferential arrangement.

There are two interesting questions in this regard. First, what proportion of FDI in the manufacturing sector of developing countries is accounted by export-oriented foreign subsidiaries? Is it high enough to justify a strong concern on an adverse effect of EC 92 on FDI in the Third World? The relevant data are obviously not available. In Asia, for example, manufacturing FDI is of relatively high importance for China, India, Malaysia, Nepal, the Philippines, South Korea, Taiwan, and Thailand (Table 1). Of these, only China, Malaysia, South Korea, Taiwan, and Thailand are likely to have attracted FDI in export-oriented manufacturing to any significant extent. Most

of this FDI is, however, from Japan and the USA. The European firms had neglected this area until the beginning of the 1980s [Hiemenz, 1987]. It is only later that the European FDI in this area began to increase. The share of Western Europe in total FDI of these countries is still less than 30 per cent [UNCTC, 1992a, p. 19f.]. Therefore, the scope for an adverse impact of EC 92 is very limited.

The second question is whether the existing advantage of comparatively lower unit costs of production for foreign investors in the developing countries will be wiped out by the advantages arising for them from the removal of all internal trade barriers in the European Community after 1992. In order to answer this question precisely, cost comparisons at the country and industry level are required, which is beyond the scope of this paper. However, the Social Charta of the Community might increase the unit costs of labour in relatively less developed areas of the Community [Langhammer, 1990]. Additional pressure can be expected from rising costs of land and environmental protection in the EC countries. Thus the tentative reasoning suggests that the cost advantage of developing countries is unlikely to be endangered by the provisions of EC 92 in the near future.

### III. Empirical Evidence

The preceding discussion leaves only a small room for a negative impact of the completion of the internal market on the inflow of FDI in developing countries. Nevertheless, it is useful to see if the data for the years after 1985 reveal a decline in the share of developing countries which can be associated with the EC 92 phenomenon.<sup>5</sup>

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<sup>5</sup> The univariate analysis of this section is obviously a very simple device to examine this question. FDI flows are usually determined by many factors. It is often difficult to separate their influences even through complex econometric techniques which require more data than are available at this stage.

According to Table 2, developing countries lost about ten percentage points of their share of total FDI in 1990 compared with 1985, and even more if we compare with earlier years. But the years before 1985 are not relevant for this analysis because it focusses on EC 92 effects. This decrease in the share of developing countries is accounted mainly by the drop in the shares of the Middle East and Latin America. In none of these cases the drop of shares can be directly related with developments in the European Community. In the Middle East, the flow of FDI is quite volatile. FDI flows in this region consist more of long-term intercompany loans than of equity capital. Moreover, the declining trend of FDI in the Middle East can be traced back to the end of the 1970s following the two oil crises. In 1979 and 1980, there was an outflow of foreign capital from this area. In the following two years, the inflow of long-term intercompany loans increased considerably. Then the declining trend set in. Both politically and economically, this region has been highly unstable. The decline in oil revenues has worsened their growth prospects. So it is mostly internal factors and not investment diversion occurring due to EC 92 which contributed to the reduced share of the Middle East FDI flows.

Table 2 -Regional Shares in Total FDI-Inflows 1981-1990 (per cent)

|                      | 1981  | 1982  | 1983  | 1984  | 1985  | 1986  | 1987  | 1988  | 1989  | 1990  |
|----------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Industrial Countries | 66.69 | 53.60 | 66.84 | 71.60 | 75.03 | 84.29 | 88.36 | 85.37 | 85.39 | 84.05 |
| of which:            |       |       |       |       |       |       |       |       |       |       |
| USA                  | 40.76 | 25.71 | 24.34 | 47.57 | 39.43 | 45.00 | 47.74 | 39.67 | 36.66 | 20.71 |
| EC                   | 25.11 | 25.46 | 30.54 | 15.91 | 29.48 | 26.42 | 29.89 | 36.24 | 39.11 | 49.38 |
| Developing Countries | 33.31 | 46.40 | 33.16 | 28.40 | 24.97 | 15.71 | 11.64 | 14.63 | 14.61 | 15.95 |
| of which:            |       |       |       |       |       |       |       |       |       |       |
| East Asia            | 5.55  | 6.26  | 6.52  | 5.51  | 5.27  | 4.45  | 4.10  | 5.35  | 5.13  | 6.85  |
| China                | ...   | 0.80  | 1.29  | 2.34  | 3.44  | 2.48  | 1.90  | 2.13  | 1.76  | 1.95  |
| South Asia           | 0.25  | 0.24  | 0.14  | 0.16  | 0.33  | 0.18  | 0.16  | 0.16  | 0.12  | 0.16  |
| Africa               | 2.40  | 3.22  | 2.41  | 2.07  | 1.55  | 0.73  | 1.14  | 0.80  | 1.39  | 0.67  |
| Middle East          | 10.18 | 22.50 | 11.98 | 11.33 | 4.62  | 3.03  | -0.11 | 0.97  | 0.97  | 0.22  |
| Latin America        | 12.43 | 11.47 | 7.13  | 6.02  | 8.33  | 4.12  | 3.46  | 4.04  | 3.50  | 4.08  |

Source: International Monetary Fund, Balance of Payments Statistics Yearbook, Washington D.C., various issues.

Also in Latin America the trend of declining share began in the 1970s, i.e. long before the initial step for the completion of the internal market was made in 1985. In 1979, the Latin American share in world FDI inflows was more than 14 per cent [IMF, 1991]. It declined to about 8 per cent in 1985 and to 4 per cent by 1990 accounting for about one half of the decline in the share of developing countries during the period under consideration (Table 2). The Latin American case also has very little to do with the provisions of EC 92. The decline during the 1980s was conditioned by adverse domestic factors, viz., high international indebtedness and the failure to service foreign loans, high inflation, poor prospects of economic growth, and budget deficits arousing the concern of investors on a future drain of resources through high taxes [Nunnenkamp, 1989]. This was in marked contrast to the 1970s, when Latin American countries experienced high economic growth and attracted relatively high amounts of FDI. By the beginning of the 1980s, Latin America was caught by the ensuing international recession and inflationary conditions. Whereas the rest of the world recovered from this economic crisis by 1983-84, Latin America could not. Persistent debt problems impaired the international creditworthiness of Latin American countries. As a result, not only the inflow of loans but also their relative attractiveness for FDI was affected seriously.

The share of East Asian developing countries in total FDI declined in 1986 and 1987 with a little more than one per cent but then recovered in the following years. In 1990, it was higher than in any of the preceding years (Table 2). Here also no conspicuous negative effect of EC 1992 can be found. On the contrary, the annual growth of FDI in East Asia during 1985-1990 was higher than for the world total [IMF, 1991]. South Asia attracts less than one per cent of world FDI inflows. There is hardly any change which can be ascribed to EC 92. However, Afghanistan, India and Nepal are not included in these data. Afghanistan was faced with war conditions and there was no inflow of FDI in that country. For India and Nepal, FDI data in the balance-of-payments statistics of the IMF appear to be incomplete. As far as national sources are available [UNCTC,

1992], they do not indicate any changes which can be attributed to EC 92.

The African share is highly volatile. On the whole, it has more than halved to about 0.7 per cent since 1985. Most of the African countries are associated with the EC, and have preferential access to its internal market including the products which are produced in their territories by foreign investors, albeit subject to the rules of origin. Therefore, the flow of FDI to these countries is least likely to be negatively affected by the completion of the Community's internal market. The decline in the African share is to be attributed to the economic and political conditions in the countries of this region [UNCTC, 1992c].

#### **IV. Concluding Remarks**

The paper covers the data upto 1990. By this time, most of the important directives of the 1992 programme of the EC had been adopted by its Council of Ministers. Further, many of the surveys showed that most of the multinational corporations have already taken into account the EC 92 as a unified single market in their strategic planning [Gittleman, 1990]. Therefore, the assumption that the impact of the EC 92 should be visible in the already available data is plausible. From these data a negative impact on the flow of FDI into developing countries is not discernible.

This is in conformity with the theoretical analysis which shows that FDI flows from developed to developing countries will largely remain unaffected by the EC 92 programme. Most of this FDI is sector and country specific, i.e. meant for the utilization of natural resources or supplying the domestic markets of host countries. A relatively small part of FDI in offshore export platforms motivated by lower costs of production in the Third World could be adversely affected. However, rising costs of labour and stricter pollution standards in Southern member countries of the Community will

tend to hinder a negative impact of the unified market on FDI flows to developing countries.

An implicit assumption underlying the investment diversion hypothesis is that the supply of funds for FDI is highly inelastic and a multinational enterprise can increase its investments in one country, say in Spain, only at the cost of another country in which it would have invested in the absence of the EC 92 programme. If investible resources were not scarce, they would not carry any value. So it cannot be denied that funds available to multinational investors are finite. This applies particularly to human capital embracing experienced and dependable international business managers. However, the high growth of total FDI in the world during the 1980s strongly suggests that the supply of investible funds responds positively to the increasing competition for FDI among countries. The supply response is likely to be further strengthened by the recent innovations of various financial instruments.

Moreover, the negative impact hypothesis ignores the growth effects of the completion of the EC internal market. It has been estimated that the removal of all restrictions on the movement of capital, goods, services and people between the member countries will add one per cent per annum or more to GDP growth of the Community [Hiemenz, 1990].<sup>6</sup> This would not only raise the available resources of the member countries for FDI in the Third World, but also increase their demand for goods produced by multinational enterprises in developing countries.

Finally, the diversion of investment will also depend on sourcing policies of the EC. If local content requirements and rules of origin as instruments of influencing the sourcing activities of firms are tightened, they would be under pressure to divert some of their investments from developing countries to locations within the Community. If the borders around the single market are kept open to imports from non-EC countries, international competition will force European firms to look for

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<sup>6</sup> Depending on the projection assumptions and whether also dynamic effects are taken into account, additional growth may be much higher [Ceccini, 1988; Baldwin, 1989].



low-cost locations in developing countries. The final shape of the external trade policy of the EC will depend also on the outcome of the Uruguay Round of multilateral trade negotiations [Sapir, 1992]. Important for developing countries is that their domestic environment for FDI is not impaired. Countries with favourable investment opportunities, good growth prospects and hospitable policies towards foreign investors will be able to more than compensate an eventual loss of FDI caused by the completion of the EC internal market.

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