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Recent FDI Trends, Implications for Developing Countries and Policy Challenges

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Introduction

To set the scene for the subsequent discussions, this brief note focuses on broad trends in foreign direct investment (FDI) and implications for developing countries. It draws primarily on the work presented in the recently published *World Investment Report 2001: Promoting Linkages.*

1. Recent trends in FDI

FDI plays a growing role in the globalization process and touches more and more countries, generating both challenges and opportunities. The scope of activities by transnational corporations (TNCs) has never been greater. UNCTAD estimates that more than 60,000 TNCs today control some 800,000 foreign affiliates worldwide. During the past one-and-a-half decades, the number of countries receiving an annual average of more than $1 billion of FDI increased from 17 to 51, almost half of which are developing countries. In 2000, global FDI flows reached the unprecedented level of $1.3 trillion. Growth rates of FDI exceeded those of other economic aggregates, such as GDP, capital formation or international trade.

But, FDI flows are not evenly distributed. In 2000, more than three-quarters ($1.0 trillion) of global inflows went to the developed countries. Inflows to Central and Eastern Europe increased by 9 per cent (to $27 billion, representing 2 per cent of world inflows). Although flows to developing countries also rose by 8 per cent (to $240 billion), the share of this group of countries in world FDI flows declined for the second year in a row, to 19 per cent, as compared to the peak of 41 per cent in 1994.

Turning specifically to recent developments among developing countries, the trends diverge. In contrast to the experience in most other parts of the world, inflows to *Africa* (including South Africa) declined in 2000 (for the first time since the mid 1990s), from $10.5 billion to $9.1 billion. As a result, the share of Africa in total FDI flows fell below 1 per cent. The decline was mainly related to two countries: South Africa and Angola. In the former country, fewer privatization and M&A deals caused the slow-down, while in the latter, inflows in the petroleum sector declined.

After tripling during the second half of the 1990s, FDI flows into *Latin America and the Caribbean* also fell in 2000, by 26 per cent, to $86 billion. This was mainly a correction from 1999 – when FDI inflows to the region were greatly affected by three major cross-border acquisitions of Latin American firms – rather than a shift in the underlying trend. Privatization slowed down in 2000, but continues to be important as a factor driving inward FDI. In terms of sectors, FDI into South America was mainly in services and natural resources, while Mexico continued to receive the largest share of inflows in manufacturing as well as in banking.

In *developing Asia*, FDI inflows reached a record level of $143 billion in 2000. The greatest increase took place in East Asia; Hong Kong (China), in particular, experienced an unprecedented FDI boom, with inflows amounting to $64 billion, making it the top FDI recipient in Asia as well as in developing countries. This upsurge in inflows has several explanations. First, it reflects a recovery from the economic turmoil of the recent past. Second, TNCs planning to invest in mainland China have been "parking" funds in Hong Kong (China), in anticipation of China's expected entry into the WTO. Third, the increase reflects a major cross-border M&A in telecommunications, which alone accounted for nearly one-third of the territory's total FDI inflows. Fourth, there is an element of increased "round-tripping" of capital flows into, and out of Hong Kong (China). FDI flows to China, at $41 billion, remained fairly stable while those to South-East Asia (ASEAN-10) remained below the pre-crisis level. The sub-region's share in total FDI flows to developing Asia continued to shrink, and stood in 2000 at 10 per cent, as compared with over 30 per cent in the mid-1990s. This was largely due to rising inflows into other countries in the region and significant divestments in Indonesia since the onset of the financial crisis. South Asia witnessed a drop in FDI inflows by 1 per cent over the previous year. India, the largest recipient in the subcontinent, received $3 billion.

2. Prospects for 2001

For the first time in a decade, FDI flows are set to decline in 2001. According to projections released just before the tragic September events in New York and Washington, world FDI flows are expected to drop by 40 per cent this year, to $760 billion. This would represent the largest relative decline in the past three decades.[1] However, the level of flows in 2001 is still expected to be higher than that in 1998 and also higher than the 1996-2000 average.

[1] FDI inflows declined in 1976 (by $6 billion or 22%), 1982 (by $12 billion or 17%), 1983 (by $7 billion or 13%), 1985 (by $3 billion or 5%) and 1991 (by $47 billion or 23%).

The projected decline in FDI is primarily the result of a decline in the value and number of cross-border mergers and acquisitions (M&As). Conversely, the significant increases in FDI flows in 1999 and 2000 - by about 50 per cent and 18 per cent, respectively – were partly driven by a number of megadeals (deals worth over $1 billion) of M&As, as represented, most prominently, by the $200 billion acquisition of Mannesmann (Germany) by VodafoneAirTouch (United Kingdom) in 2000. The decline in M&As – both cross-border and domestic – is related to the slowdown in the world economy. The prices of shares, for example, which in 2000 were used to finance more than half of all cross-border M&As, fell significantly, when measured in terms of the exchange of stocks. A lull in the consolidation processes in certain industries through M&As (e.g. telecommunications, automobiles) also plays a role.

The parallel path of FDI flows and cross-border M&As is more pronounced in developed than in developing countries, partly because most FDI in the latter countries is greenfield investment. Hence, FDI flows are expected to decrease significantly in developed countries, from $1.005 trillion in 2000 to an estimated $510 billion in 2001, i.e. by 49%. In the case of developing countries, the decline is estimated to be 6%, from $240 billion to $225 billion. Decreases in FDI inflows are expected in both Latin America and developing Asia. As a result, the share of developing countries in world FDI inflows may rise to 30 per cent – after a number of years of steady decline – higher than the share attained in 1998. FDI inflows in Central and Eastern Europe are expected to remain stable in 2001.

3. The impact of 11 September

In light of the principal determinants of FDI flows, the tragic events of 11 September may further accentuate the projected decline in 2001. The most important economic determinants of FDI are related to market size and market growth. Due to a weakening of demand in some of the world's largest economies, these variables have already had a sobering effect on FDI. To the extent that the events in the United States accentuate the economic slow-down, it would lead to a further decline of FDI flows. Moreover, the higher level of uncertainty, in particular due to increased political risk (risk associated with war and terrorism), may induce some companies to adopt a "wait-and-see" position and put planned investment on hold until they gain a better comprehension of the longer term impact of the events in the United States.

The impact is likely to be uneven, however, affecting various industries as well as markets in different ways. Industries that may be especially negatively affected include transportation service, aeroplane manufacturing, insurance and financial services, and tourism; this would affect their capacity to invest abroad. The level of economic growth furthermore varies considerably by country. TNCs may continue to expand in markets that are still growing at a decent pace or have a potential to do so.[2]

An accentuation of the slow-down in the economy would add to the competitive pressure in many industries, forcing companies to enhance their cost-efficiency. Faced by more severe price-driven competition, some TNCs may choose to relocate certain production resources to low-cost producing countries; in this case there may be some redistribution of FDI flows towards developing countries and transition economies. Such restructuring may have a longer-term impact on the production systems of TNCs.

[2] For example, several telecommunications companies, like Ericsson and Motorola, have recently announced significant increases in their investments in China in the coming years.

The immediate impact of the crisis on stock markets will probably accentuate the current decline in M&As. A sharp drop in share prices after the events of 11 September may further reduce the purchasing power of acquirors as shares are used to finance the acquisitions of target firms. On the other hand, as the prices of specific companies become lower, this may trigger new M&As, as happened at the time of the Asian financial crisis. Whereas cross-border M&A activity in the short term is likely to be further dampened, the underlying determinants of M&As still suggest that this mode of FDI entry will continue on an upward trend (UNCTAD, 2000).

Hence, to the extent that the tragic events in the United States accentuate the world economic slowdown, and to the extent that FDI flows tend to be pro-cyclical, this is likely to lead to a further decline in FDI, beyond the forecasted 40 per cent decline. Total FDI flows in 2001 may even approach the 1998 level of less than $700 billion. It is still too early, however, to tell whether the 11 September events will have more than a short-term effect on FDI. The longer-term implications depend on how extended the present heightened level of political uncertainty will be and, especially, on the reduced level of demand in the world economy. The key policy challenge is to help restore confidence among consumers and investors in order to contribute to a quick recovery of economic growth and thereby FDI. The concerted actions among developed countries to counter the economic slowdown, notably through expansive fiscal measures and a lowering of interest rates, are likely to play an important role to this effect.

4. Evolving policies to promote FDI

The decline of FDI flows may lead countries to step up their efforts to attract FDI and to try to secure greater benefits from FDI received. FDI promotion policies are gradually evolving. In the *first generation* of investment promotion policies, countries simply liberalize their enabling frameworks for FDI to attract more investment. This continues to take place throughout the world. UNCTAD data show that, in 2000 alone, out of some 150 FDI regulatory changes made by 69 countries, 98 per cent were in the direction of creating a more favourable environment for FDI. While such (in a sense passive) liberalization is important to attract much desired investment, it is usually not sufficient in the increasingly competitive world market for FDI. Consequently, in the *second generation* of investment promotion policies, countries actively "market" their countries as locations for FDI. This approach, which typically includes the setting up of national investment promotion agencies, has been widely adopted by developed as well as developing countries. To illustrate, the World Association of Investment Promotion Agencies, created as recently as in 1995, today has more than 110 members. The *third generation* of investment promotion policies takes an enabling framework for FDI and a proactive approach towards attracting FDI as a starting point. It then proceeds to target foreign investors (in accordance with a country's developmental priorities) at the level of industries and firms and seeks to meet their specific locational needs.

A targeted approach is not only becoming more important to face up with the growing competition in the area of investment promotion, it is also desirable from the perspective of achieving an efficient use of scarce resources. Targeting may furthermore help policy makers to improve their understanding of corporate strategies and of the specific locational assets and liabilities that characterize their host countries. An "honest" assessment of the ability to meet the requirements of specific investors is important to decide on what activities and firms to target. There is no one-size-fits-all formula to apply. Instead, the approach has to take the specific circumstances of each country into account. Targeting is an ongoing process and needs to be adapted to, and to develop with, the evolving objectives (employment generation, promotion of competition, generation of exports, technology inflow or upgrading of the domestic enterprise sector) and locational capabilities of countries.

5. Linking FDI to the domestic enterprise sector

The increased attention paid to investment promotion activities suggests that the advantages FDI can offer are quite widely acknowledged as of today. In addition to capital inflows, FDI can lead to transfers of technology and know-how, improve the access to international markets and spur competition. However, such benefits cannot be taken for granted. Countries need to ensure an appropriate framework in key policy areas. One important area that, in this context, has, so far, received relatively little attention relates to supply linkages between foreign affiliates of TNCs and local firms.

Promoting linkages is potentially a win-win-win proposition. Benefits may accrue to foreign affiliates, local firms as well as to the host countries in which they are struck. *Foreign affiliates* may seek to use local suppliers in a host country to reduce costs, increase flexibility and expand sales. Outsourcing and sub-contracting raise the need for inter-firm linkages. In fact, supply chain management has become critical for the competitiveness of many firms. A manufacturing firm spends on average more than half its revenues on purchased inputs. In response, some TNCs have organized special development programmes in host developing countries to assist potential or existing suppliers. The experience from various companies illustrates how companies in different industries and host countries can actively support suppliers to upgrade their technology, productivity and ability to compete internationally.

Local firms can benefit by becoming part of global production networks of TNCs, through increased sales and from productivity-enhancing information and knowledge transmitted from foreign affiliates. Linkages constitute the strongest channel for diffusing skills, knowledge and technology from foreign affiliates to local firms and institutions.

Host countries can benefit when linkages contribute to the upgrading of domestic enterprises and as foreign affiliates become more firmly embedded in the host economy. For developing countries, the formation of backward linkages, through which foreign affiliates purchase parts, components or services through various forms of outsourcing or subcontracting arrangements, assumes particular importance.

However, the extent to which foreign affiliates forge linkages with domestic suppliers (as opposed to, say, using imports) is determined by the cost-benefit ratio of such efforts, as well as by differences in firm-level perceptions and strategies. The most important factors are related to corporate strategy and the availability of supply capacity. A lack of efficient domestic suppliers is a common obstacle to the creation of linkages, particularly in developing countries. Building on the basic self-interest of firms in backward linkages, policy makers in host countries therefore have an important role to play in influencing the willingness of foreign affiliates to use local suppliers. In particular, they can address specific obstacles to the linkage formation process by raising the benefits and/or reducing the costs of using domestic suppliers. For example, TNCs may be unaware of the availability of viable suppliers, or they may find it just too costly to use them as sources of inputs.

Drawing on the experience of a wide range of countries, a menu of specific measures can be considered to promote linkages. These measures pertain to the provision of information and matchmaking; encouraging foreign affiliates to participate in programmes aimed at upgrading the technological capabilities of domestic suppliers; establishing training programmes in partnership with foreign affiliates for the benefit of domestic suppliers; and various schemes to enhance domestic suppliers' access to finance.

A few countries – Costa Rica, the Czech Republic, Ireland, Malaysia, Singapore and the United Kingdom, for example – have, often with considerable success, set up comprehensive linkage development programmes involving a combination of different policy measures and targeting selected industries and firms.

Indeed, well-targeted government support can tilt the balance in favour of more linkages and thereby contribute to knowledge transfers from TNCs that can foster the development of a vibrant domestic enterprise sector. As laid out in more detail in the *World Investment Report 2001 (UNCTAD, 2001)*, linkage promotion policies need to be consistent with and embedded in a broad range of policies that support enterprise development and FDI promotion. The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of the host economy and of the challenges it faces in a globalizing world. A linkage programme should, in particular, address the competitive needs of domestic enterprises and the implications these have for policies, private and public support institutions and support measures (including skills- and technology-upgrading). It is advisable for policy makers that choose this approach to "start small" (perhaps with a pilot scheme) and to build policy monitoring, flexibility and learning into the programme. The need for starting small is all the greater when resources are scarce. Moreover, it is essential for any programme to seek close collaboration with the private sector, both foreign affiliates and domestic suppliers, in design and implementation.

Governments can act as facilitators and catalysts and ensure that private institutions have the incentives and resources needed. They can be particularly pro-active in the following key areas of linkage formation: information and matchmaking; technology upgrading; training; access to finance. The range of measures that can be taken in each of these areas is wide. Their principal purpose is to encourage and support foreign affiliates and domestic firms to strike up and deepen linkages. Specific choices depend on the results of earlier consultations with existing support institutions and relevant programmes in the public and private sectors, as well as with key stakeholders on the specific needs of an industry or set of firms. Governments could also encourage participating foreign affiliates to agree to a coaching and mentoring arrangement with promising local firms.

Linkage programmes can only work if they are networking effectively with efficient intermediate institutions providing support in skill building, technology development, logistics and finance. These include standards and metrology institutes, testing laboratories, R&D centres and other technical extension services, productivity and manager training centres and financial institutions. These can be public or private. It is also important that linkage programmes work closely with relevant private associations – chambers of commerce and industry, manufacturers associations, investor associations and so on. Trade unions and various interest groups are other important stakeholders. Finally, it is important to have a monitoring system in place to evaluate the success of a programme. Often, in a learning-by-doing process, a programme needs to be adjusted and refined as experiences accumulate and situations change. The system could include benchmarks and surveys of users.

In conclusion

With FDI stocks in countries having accumulated rapidly while new FDI flows are declining, it becomes all the more important to make greater efforts to attract new FDI and increase the benefits from existing foreign affiliates. Strengthening linkages has an important role to play here, and policy makers can help realizing such linkages. In addition, firms around the world can be encouraged to study the experience of some of their competitors in strengthening their supplier linkages, with a view to emulating them for their own corporate systems. As is often the case, the best results can be reached through close public-private collaboration.

References

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