Foreign direct investment and developing countries

Foreign investment disputed

Foreign direct investment (FDI) is often seen as the best way to boost the economies of developing countries. But this is only true under strict conditions. If those conditions are not met, FDI can even hamper economic development.

By **Evert-jan Quak**

In Western Europe or North America, if a business that is strategically important to the local economy threatens to fall into the hands of a foreign competitor, it always leads to heated discussions. This happened recently during the largest takeover ever seen in the banking sector. A consortium consisting of Fortis (Belgium), the Royal Bank of Scotland (UK) and Santander (Spain) acquired the Dutch bank ABN Amro. In the Dutch newspaper *De Volkskrant* an insider commented: 'A great bank, which took nearly two hundred years to build up, is now being ripped apart like a deer by wolves'.

Why this emotional reaction? Politicians – and not only in the Netherlands – have spent the past three decades deliberately trying to make it easier for businesses around the world to invest abroad. The underlying notion is that foreign investments are good for a country's economic growth. New capital flows into the country, greater competition leads to higher productivity, and the country benefits from the new technology and management know-how that foreign investors bring with them.

Foreign direct investment (FDI) is assumed to be especially beneficial for developing countries. The World Bank, the International Monetary Fund (IMF) and many other external advisers have therefore urged them to attract as much FDI as possible to stimulate the economic growth they so desperately need. In their view, FDI is better than all other capital flows because it is difficult to move around and therefore does not dissipate again quickly if the economic situation becomes unfavourable.

Levels of FDI remained very stable, for example, during the 1980s and 1990s. Because of its stability, Cambridge economist Ha-Joon Chang has called FDI the 'Mother Teresa of foreign capital', while Ricardo Hausmann and Eduardo Fernández-Arias of the Inter-American Development Bank (IDB) have described FDI as working like 'good cholesterol' on the global economy.

10% equity stake

In the past ten years, many economic researchers have attempted to map out the precise effects of FDI on developing countries. The theory of FDI has been refined and can be tested against a large body of empirical research. But first it is important to explain exactly what FDI is and how it is distributed worldwide.

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FDI does not always mean the construction of a new factory by a multinational concern, as is often assumed. It simply says something about the way an investment is financed. If a foreign company or consortium acquires an equity stake of more than 10% in a local business, then it is categorized as FDI. In fact, most FDI (80% worldwide) is in the form of takeovers of local businesses by foreign companies. This involves not the creation of new economic activity, but simply a change of ownership.

Such investments must also be financed abroad to count as FDI. If the money comes from local banks it is not seen as FDI, since the capital does not enter the country from elsewhere. In the case of a takeover, the former owner can use the money for consumption or investment abroad. If that happens – as it did in Latin America in the 1990s when a large number of public companies were privatized – FDI does not contribute to capital formation and growth in the country concerned.

FDI – an 'inferior good'?

According to the 2006 edition of UNCTAD's authoritative annual *World Investment Report*, the value of all FDI worldwide rose by 29% in 2005, to US$916 billion. Inflows to developing countries rose to a record US$334 billion, or 36% of the total. The lion's share of FDI to developing countries went to those with buoyant economies, usually larger middle-income countries like Brazil, China, India and South Africa. Of the US$31 billion (just 3% of the total) invested in Africa in 2005, 21% went to South Africa. Egypt was the second largest recipient, followed by Nigeria. The 34 least developed countries (LDCs) in Africa attracted very little FDI. The largest proportion of FDI in Africa was in the primary sectors, especially oil, agriculture and mining, with little in the manufacturing or service sectors, especially in the LDCs.

Research by Hausmann and Fernández-Arias (IDB) shows that capital flows tend to increase with the level of development. However, the share of those flows that take the form of FDI tends to be higher for the poorest countries than for richer ones. A larger share of FDI in capital flows is typical of countries that are poorer, more closed, riskier, more volatile, more distant, less financially developed, with weaker institutions and with more natural resources. 'FDI seems to be an inferior good in the sense that its share tends to fall with income', say Hausmann and Fernández-Arias. 'It is total capital that appears to go up with economic development while the share of FDI declines'.

In percentage terms, poor countries are therefore most dependent on FDI. But at the same time, they find it the most

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difficult to attract FDI because investment in these countries is very high risk, their infrastructure is poor, and they often lack stable institutions. Is that good or bad for the economic development of a country?

Crowding-out

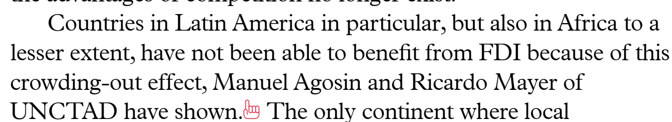
Empirical research can establish whether FDI really is the panacea for developing countries that the World Bank and the IMF have claimed for so many years. It shows that FDI can give an economy a strong boost, but only under certain strict conditions. If those conditions are not in place, FDI can even have an adverse effect on economic development.

In theory, knowledge transfer is the most important pillar of development. The presence of a multinational concern enables local businesses to imitate or adopt the latest technology and know-how. This can result in higher productivity in the sector and a better export position for the country. In practice, however, it is not that simple. Foreign investors do not voluntarily pass on their know-how to their competitors, but only to some suppliers. To reap the maximum benefit, those suppliers must be located as close as possible to the multinational concern.

But the multinational might choose to make little use of local suppliers and import as much of the inputs it needs as possible. If that happens, the transfer of knowledge is limited. It is also disadvantageous for the country's balance of trade. Only strong countries can force foreign investors not to do this. When Nissan wanted to open a factory in the UK in 1981, for example, it had to agree to purchase 60% of its inputs locally, rising to 80% in the longer term. The same condition applied to Ford and General Motors – in a country governed at the time by a 'liberal' prime minister, Margaret Thatcher.

Developing countries do not have the power to impose such conditions. It is easier in these countries for foreign investors to out-compete local businesses. If a respectable number of efficient local companies can survive and continue to compete with multinationals, the disappearance of a large number of inefficient businesses can be beneficial in the long term. But if a multinational acquires a monopoly in the local market by crowding out local competitors, the advantages of competition no longer exist.

Countries in Latin America in particular, but also in Africa to a lesser extent, have not been able to benefit from FDI because of this crowding-out effect, Manuel Agosin and Ricardo Mayer of UNCTAD have shown. The only continent where local businesses have been able to reap significant benefits is Asia, where FDI regimes 'have remained the least liberal in the developing world. Several Asian countries still practice screening of investment applications and grant differential incentives to different firms'.



Many of the poorest countries in Africa are caught in the trap of dependence on natural resources. The effect of FDI on the economic development of these countries appears to depend heavily on the sector in which investments are made. The advantages of FDI apply more to the manufacturing sector than to the primary sector. In Central America, for example, banana producers such as Chiquita operate as enclaves with no linkages at all with other economic activities in the region. If these foreign companies were to depart, they would leave little behind to contribute to further economic growth.

This contrasts sharply with the labour-intensive manufacturing sector in Asia. Foreign investors only invest in the manufacturing sector of a country if they think that they can operate more efficiently than local producers. These investors will be more likely to help suppliers to perform better, because it is in their interests to do so. In other words, efficiency-seeking FDI can not function without interacting with the local environment. Resource-seeking FDI in the primary sector, on the other hand, is much less prepared to interact.

One problem with efficiency-seeking FDI is that it is attracted primarily by low wages and can therefore spark off a 'race to the bottom'. If wages go up, the investor is likely to move production to other regions where labour is cheaper. If local linkages have not been created, the investor will depart without leaving anything behind.

There is also market-seeking FDI, in which investors seek new markets for their products or services, especially in the service sector. This can lead to knowledge transfer but, in the long-term, this form of FDI has no impact on the host country's balance of payments because the investment is aimed purely at local consumers and not at exports of products or services.

Development paradox

Developing countries are therefore confronted with a paradox. In order to benefit from FDI, they need to have achieved a certain level of economic development, or 'absorptive capacity', as it is known in economic jargon. Countries that do not have enough capacity can not absorb the superior knowledge and technological know-how that foreign investors can provide. And it is developing countries >

that lack absorptive capacity. As Sanjaya Lall of the University of Oxford observed, in countries 'with weak local capabilities, industrialization has to be more dependent on FDI. However, FDI cannot drive industrial growth without local capabilities'.

From the evidence emerges the idea that policy makers have for many years been asking the wrong question. For developing countries, the main challenge is not how to attract as much FDI as possible, but to decide on what kind of FDI to attract. This implies that it must be possible to regulate inflows of FDI. Yet the abolition of rules that impede FDI is one of the items on the agendas for the current rounds of talks on free trade agreements. Since the success of FDI is so dependent on specific characteristics that vary between countries, sectors and investments, developing countries must have in place adequate FDI-related policy instruments. They can then extract maximum benefit from FDI by encouraging it where they expect to profit from foreign investors. But they must also be able to refuse FDI if it is likely to distort local markets and out-compete local businesses.

Selective protectionism

This is what many Asian countries and almost all developed countries have done. As Ha-Joon Chang showed in his book *Bad Samaritans*, countries like the US and the UK, which are the greatest advocates of removing obstacles to FDI, have themselves not been open to FDI in important sectors such as banking or the automobile industry.

The recent success of Nokia, the world's largest mobile phone company, provides a good example. The Finnish company took 17 years to make a profit, but it could afford to take that long because it was protected against hostile takeovers by the government. Like Nokia, many of today's multinationals were protected in their early years against foreign takeovers. If they had been taken over, they would not have been the multinationals they are now.

Do we need a new political agenda? Sanjaya Lall, one of the pioneers of research into FDI, and Rajneesh Narula answered this question by noting that many researchers are 'unanimous in their skepticism of the Washington consensus and the rather simplistic view taken by certain mainstream economists that FDI is a *sine qua non* for economic development. Market forces cannot substitute for the role of governments in developing and promoting a proactive industrial policy'. ■

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Safe havens

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Recovery Programme to ensure the return of as many of them as possible. According to the programme's director-general, China is pursuing a strategy of buying the objects back in preference to instigating legal procedures. In 80% of cases, such purchases are made through private channels, and often involve very large sums of money. In early 2007, for example, a Chinese billionaire paid nearly €6 million for a bronze horse's head through Sotheby's auction house in Hong Kong, and then donated it to the Chinese government.

Old manuscripts are sometimes returned in microfiche form. In 2002 the university libraries of Uppsala (Sweden) and Leiden (the Netherlands) and the Chester Beatty Library (Dublin, Ireland), presented the Institute of Ethiopian Studies in Addis Ababa with microfilms of several hundred Christian and Islamic manuscripts, some dating back to the sixteenth century. Many manuscripts have left Ethiopia over the centuries, with large quantities being sold in the 1980s. 'The situation in Ethiopia was bad at that time', explains Jan Just Witkam of Leiden University Library, 'and many churches and monasteries were willing to sell manuscripts'. He purchased many boxes full of old books and scrolls. 'Because the prices were so favourable, I accepted every package'. Witkam says that even if Ethiopia wanted the manuscripts back and the cultural authorities requested their return, he would not consider it.

The trade in stolen art and antiquities belonging to vulnerable peoples and fragile states has gone on throughout history, fuelled by conflict, political instability, poverty and changing values. There are several steps that defenders of cultural heritage can take if, for example, a government or a rebel movement neglects or threatens to destroy a country's cultural heritage. Among these, the idea of creating 'temporary' safe havens is becoming increasingly accepted. At the same time, countries in the South have become more vocal in their demands that the major museums return the many artefacts they acquired in the past. All of these issues demand urgent attention, as the theft and smuggling of art and antiquities are on the increase, due partly to the growing numbers of wealthy travellers and private collectors. While there is no easy answer to the question of how to protect these treasures more effectively, whatever is done will require the full commitment of all concerned. ■

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