Foreign Direct Investment (FDI) in the Context of Trade and Economic Development

Dharma de Silva

Abstract

Foreign Direct Investment (FDI) is a driving force of globalization and an important engine of economic growth. Historically, developed countries pioneered by transnational (TNC) or multinational corporations (MNC) benefited immensely by FDI and developing countries via public policy measures increasingly began to seek and attract FDI due to its many advantages for economic development. FDI not only brings capital to an economy, but also transfers knowledge, technology, managerial skills, and best practices. It also generates employment and advances trade. Foreign direct investment has played a critical and growing role in the global economy, assisted by accompanying absorptive capacities. To a host country, FDI promises a source of new resources and new technologies that could spur national economic growth and development in various sectors. Evidence of FDI influence on economic growth figures prominently both in theoretical and empirical studies, focusing on a large number of developing nations; among them cited in the paper are strong growth in regional FDI inflows in South, East & S-E Asia, e.g., China, India, Malaysia, and Sri Lanka. To a home country TNC or MNC, FDI offers the promise of new markets, a mode-of-entry beyond exporting and less expensive export-led production facilities. This current paper draws on reports, findings and reviews, and relies on the existing FDI statistical systems, reported by the UNCTAD World Investment Report 2009, World Investment Prospects Survey 2009, IMF, EIU, among others cited, to examine the various issues related to FDI definitions, trends, perspectives, policies and significant operations during the past two decades, the decline during the global economic crisis (2007-2009), and prospects for 2010-2011.

Key terms: FDI, International Production, Economic Growth, absorptive capacity, competitiveness, productivity, TNC/MNC, BRIC, BRICKS(Brazil, Russia, India, China, Korea, South Africa) TRIAD’s JUG(Japan, USA, Germany), CHINDIA (China and India) and Sri Lanka BOI & FDI.

Dharma de Silva, Ph.D., FPBA, FCMI (UK), Professor & Director, Center for International Business Advancement, Chair, World Trade Council Wichita Inc, Barton School of Business, WSU, USA.
1. Introduction

This paper on FDI is presented against the backdrop of the deepest global economic slowdown since the great depression of the 1930’s. What began as a financial crisis in a handful of industrialized economies continued to spill over into the global economy, engendering massive contractions in consumer demand, rising unemployment, and mounting protectionist pressures worldwide. A large number of developing countries have not been spared from its fallout; many are now facing slumping demand for their export products along with falling commodity prices, significant reductions in foreign direct investment and remittances, and a more general liquidity shortage. The strong interdependence among the world’s economies makes this a truly global economic crisis, causing a sharp decline in FDI and economic growth slowdown. The annual UNCTAD World Investment Reports and a fund of literature, both theoretical and empirical, many cited in this paper enable the analysis of FDI rise during two decades, recent fall and policy implications of the global slowdown/crisis from 2007 going into 2008 -2009; and look at 2009 WIPS on FDI prospects for 2010-2011. These findings are also in line with those of other sources, such as GCR/WEF. EIU, the IFO Global Business Index (IFO, 2009) and OCO Global 2008-2009, 12th Annual CEO Survey. Over the past twenty years, FDI inflows have expanded substantially, from approximately $40 billion at the beginning of the 1980s to $200 billion in 1990, to over $1.9 trillion in 2008. Cross-border mergers and acquisitions (M&As) are the principal drivers of this growth, as they are the main form of FDI in the developed world and an increasingly important one in emerging markets.

Specifically, global foreign direct investment flows fell moderately in 2008, following a five-year period of uninterrupted growth, in large part as a result of the global economic and financial crisis. While developed economies were initially those most affected, the decline has now spread to developing countries, with inward investment in most countries falling in 2009 too. The decline poses challenges for many developing countries, as FDI has become their largest source of external financing. Greater involvement by TNCs (MNCs) not only lead to greater productivity in manufacturing, agriculture and rural development essential to economic growth, but also to the alleviation of poverty and hunger. Although the present major economic crisis began in the advanced economies, it rapidly spilled over to the developing world through the contagion mechanisms of reductions in trade, foreign direct investment, remittances, and other types of financing. Although GDP growth rates in emerging markets have not fallen as much as they have in advanced economies, the notion that the developing world would be only marginally affected by the crisis, having decoupled from the business cycle of industrialized economies, has not held true. However, it is important to note that the crisis has not affected developing countries in a homogenous way; some economies are showing a higher resilience and even managing to enhance their competitiveness in the midst of the global downturn. According to IMF Update, the global economy is beginning to pull out of a recession unprecedented in the post-World War II era, but stabilization is uneven and the recovery is expected to be sluggish. Economic growth during 2009–10 is now projected to be about ½ percentage points
higher than projected in the April 2009 World Economic Outlook, reaching 2.5 percent in 2010. Financial conditions have improved more than expected, owing mainly to public intervention, and recent data suggests that the rate of decline in economic activity is moderating, although to varying degrees among regions.

The United States, along with China, India, Brazil, Russia Korea, and South Africa (BRICKS’ countries) are likely to lead the future FDI recovery, as indicated by the responses of large TNCs cited in WIPS 2009. Developing countries, emerging economies and countries in transition have come increasingly to see FDI as a source of economic development and modernization, income growth and employment. Countries have liberalized their FDI regimes and pursued other policies to attract investment. The overall benefits of FDI for developing country economies are well documented.

Given the appropriate host-country policies and a basic level of development, a large number of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for alleviating poverty in developing countries. Moreover, beyond the strictly economic benefits, FDI may help improve environmental and social conditions in the host country by, for example, transferring “cleaner” technologies and leading to more socially responsible corporate policies. Advanced countries as well as BRICKS transnational and multinational corporations are engaging increasing outward FDI outflows and reshaping the geography of investing, manufacturing, marketing, supply chains and countertrading. Although evidence focuses on the positive effects of FDI for economic development, it also addresses concerns about potential drawbacks for host economies, economic as well as non-economic, as identified and illustrated in Exhibit 1 “Advantages vs. Disadvantages of Foreign Direct Investment Decisions”.

Fig 1: Selected Indicators of FDI and international production, 1982-2008

<table>
<thead>
<tr>
<th>Item</th>
<th>Value at current prices (Billions of dollars)</th>
<th>Annual growth rate (Per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI inflows</td>
<td>(1992) 28.1</td>
<td>(2002) 42.1</td>
</tr>
<tr>
<td>FDI outflows</td>
<td>(1992) 15.6</td>
<td>(2002) 42.1</td>
</tr>
<tr>
<td>FDI outflows</td>
<td>(2002) 42.1</td>
<td>(2007) 42.1</td>
</tr>
<tr>
<td>FDI inward stock</td>
<td>1992 154</td>
<td>2002 39.4</td>
</tr>
<tr>
<td>FDI outward stock</td>
<td>2002 39.4</td>
<td>2004 38.4</td>
</tr>
<tr>
<td>FDI inward stock</td>
<td>2004 38.4</td>
<td>2005 36.8</td>
</tr>
<tr>
<td>FDI inward stock</td>
<td>2005 36.8</td>
<td>2006 35.8</td>
</tr>
<tr>
<td>Cross-border M&amp;As</td>
<td>2006 35.8</td>
<td>2007 34.8</td>
</tr>
<tr>
<td>Sales of foreign-affiliates</td>
<td>2 530</td>
<td>2 530</td>
</tr>
<tr>
<td>Gross product of foreign affiliates</td>
<td>6 263</td>
<td>6 263</td>
</tr>
<tr>
<td>Total assets of foreign affiliates</td>
<td>5 939</td>
<td>5 939</td>
</tr>
<tr>
<td>Exports of foreign-affiliates</td>
<td>2 395</td>
<td>2 395</td>
</tr>
<tr>
<td>Employment by foreign-affiliates (thousands)</td>
<td>7 702</td>
<td>7 702</td>
</tr>
<tr>
<td>GDP (in current prices)</td>
<td>11 963</td>
<td>12 121</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>2 795</td>
<td>2 795</td>
</tr>
<tr>
<td>Exports of goods and non-fuel services</td>
<td>2 385</td>
<td>2 385</td>
</tr>
</tbody>
</table>

a. Data are available only from 1987 onwards. b 1987–1990 only. c Data for 2007 and 2008 are based on the following regression result of sales against inward FDI stock (in $ million) for the period 1980–2006: sales = 1471.6211 + 1.9343 * inward FDI stock. d Data for 2007 and 2008 are based on the following regression result of gross product against inward FDI stock (in $ million) for the period 1982–2006: gross product = 566.7633 + 0.3658 * inward FDI stock. Data for 2007 and 2008 are based on the following regression result of assets against inward FDI stock (in $ million) for the period 1980–2006: assets = -3387.7138 + 4.9069 * inward FDI stock. e Data for 1995–1997 are based on the following regression result of exports of foreign affiliates against inward FDI stock (in $ million) for the period 1982-1994: exports = 139.1489 + 0.6413 * FDI inward stock. For 1998–2008, the share of exports of foreign affiliates in world export in 1998 (33.3 %) was applied to obtain the values. f Based on the following regression result of employment (in thousands) against inward FDI stock (in $ million) for the period 1980–2006: employment = 17642.5861 + 4.0071 * inward FDI stock. h Based on data from IMF, World Economic Outlook, April 2009.

2. The Role of FDI in International Production and TNC Performance

Currently, as cited in WIR 2009, there are some 82,000 TNCs/MNCs worldwide, with 810,000 foreign affiliates. These companies play a major and growing role in the world economy. For example, exports by foreign affiliates of TNCs (MNCs) are estimated to account for about a third of total world exports of goods and services, and the number of people employed by them worldwide totaled about 77 million in 2008. The largest TNCs/MNCs contribute to a significant proportion of total international production by all TNCs, both in developed and developing economies. Over the three-year period 2006–2008, on average, the 100 largest non-financial TNCs accounted for 9%, 16% and 11%, respectively, of the estimated foreign assets, sales and employment of all TNCs in the world (Fig. 1). They also accounted for about 4% of world GDP, a share which has remained relatively stable since (2000.20?) This section analyses the major trends and recent developments with respect to the largest TNCs, and examines the impacts of the ongoing financial and economic crisis on these firms and their international activities. Over the past 15 years, the largest TNCs have undergone a steady process of progressive increase in the proportion of companies operating in the services sector, and of firms based in developing countries. These largest TNCs are presently being strongly affected by the ongoing economic and financial crisis, both at company and industry levels, as evidenced by declining profits, divestments and layoffs, restructurings and some bankruptcies. According to preliminary estimates, the (increase in?) have slowed down markedly in 2008. However, an UNCTAD survey shows that, despite a temporary setback in their investment plans in the short term, large TNCs expect to continue (to?) in the medium term, with a growing focus on emerging markets.
A widespread negative impact in the short-term: Buffeted by the growing global financial and economic crisis, TNCs around the world reduced their FDI in 2008, compared to 2007, thus ending a nearly five-year period of uninterrupted growth. This decline, most pronounced in developed economies to 11.9%, was also apparent in developing economies where the rate of growth of FDI slowed down to a flat 2%. FDI outflows and cross-border M&A purchases by region and major country 2007-2008 are shown in Fig. 2. (72) Responses to the WIPS 2009 survey clearly confirm the global nature of the economic and financial crisis, as FDI prospects are affected in similar ways, regardless of the home region of the company. As stated earlier, recovery is expected in all home regions in 2011 and the views of TNCs of their global FDI environment and of their own FDI prospects improve markedly over time. This progressive return to optimism can be observed in all home regions. (77)(79)

3. How are TNCs Coping with the Economic Crisis and Impact on FDI?

According to WIP Survey 2009, “TNCs seemed rather optimistic about the evolution of the global economic outlook in the medium term, and appeared willing to continue internationalizing their operations. They might, therefore, progressively resume their investment plans, albeit only moderately in 2010, and gaining momentum in 2011. Business executives expressed less negative views for the medium term than for 2009. Roughly 45% of them were “optimistic” or “very optimistic” about the global business environment for 2011, as compared to 10% for 2010 and 0% for 2009”.

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![Fig 2: FDI outflows and cross-border M&A purchases, by region and major economy, 2007-2008 ($bn)](source: UNCTAD. *Preliminary estimates. See UNCTAD’s World Investment Report 2009 (forthcoming for final figures).*)
In addition, the crisis will not affect the overall trend towards further internationalization of companies’ activities. For instance, nearly 48% of respondents said they intended to carry out more than half of their investments abroad in 2011, as against only 41% in 2008.

This trend towards greater internationalization appears to cover all business functions, including those that are at present less internationalized, such as research and development (R&D). Around 48% of respondent companies reported their intention to undertake more than half of their R&D abroad in 2011, compared with 41% in 2008.

TNCs’ shrinking corporate profits and plummeting stock prices have greatly diminished the value of, and scope for, cross-border mergers and acquisitions (M&As) – the main mode of FDI entry in developed countries, and increasingly in developing countries as well.

Large decreases in M&As Cross-border M&As in general have been strongly affected as a direct consequence of the crisis, with a 35% decline in their value in 2008 compared with 2007. A fall was also recorded for the first half of 2009, to $123 billion. In particular, in 2008 there was a global reduction in the number and value of mega deals (i.e., cross-border M&As valued at more than $1 billion). The number of such deals fell by 21% and their value by 31%. The decrease in total cross-border M&As has had a significant impact on FDI flows, as they are strongly correlated with the value of cross-border M&A transactions.

FDI flows have fallen mainly for the following reasons: through cross-border M&As or Greenfield projects, are falling; and/or other transfers of funds (e.g., repayments of debt, reverse loans) from existing foreign affiliates to their parent firms are exceeding new investments by parent firms.

When considering the impact of the crisis on FDI-related policies, so far, the current financial and economic crisis has had no major impact on FDI policies per se, since FDI is not the cause of this crisis. However, some national policy measures of a more general scope (national bailout programmes as a response to the crisis) are likely to have an impact on FDI flows and TNC operations in an indirect manner. They may have a positive effect on inward FDI as they could help stabilize, if not improve, the key economic determinants of FDI discussed later in this paper.

4. The ABC’S of FDI - Definition and Application Issues

According to the IMF’s Balance of Payments Manual, along with OECD’s Benchmark Definition of Foreign Direct Investment, FDI is defined as: ‘(...) the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an economy other than that of the investor (“direct investment enterprise”).

FDI can be categorized into three components: equity capital, reinvested earnings and intra-company loans. Equity capital comprises the shares of companies in countries foreign to that of the investor. Reinvested earnings include the earnings not distributed to shareholders but reinvested into the company. Intra-company loans relate to financial transactions between a parent company and its affiliates (UNCTAD 2006). FDI data is usually reported in terms of stocks and flows. FDI stock refers to the value of capital and reserves plus net indebtedness, whereas FDI flow refers to capital provided by or received from a foreign direct investor to an FDI enterprise. FDI flows can be further classified as inflows (capital flows into the host economy) and outflows (capital flows out of the home economy).

International Monetary Fund (IMF) guidelines consider an investment to be a Foreign Direct Investment (FDI), if it accounts for at least 10% of the foreign firm's voting stock of shares. However, many countries set a higher threshold because 10% is often not enough to establish effective management control of a company or demonstrate an investor's lasting interest. FDI is now more important than trade as a vehicle of international transactions and increasingly sought by emerging countries. FDI that establishes a lasting interest in or effective management control over an enterprise can include buying shares of an enterprise in a host country, reinvesting earnings of a foreign-owned enterprise in the country where it is located, and parent firms extending loans to their foreign affiliates. Overseas production facilities comprise a large and increasingly vital part of international companies' global strategies. FDI in the service sector (especially banking and finance) grew rapidly in the last decade, as did FDI in technology-intensive manufacturing and business information services. Due to its economic significance and social impact, FDI statistics have become an essential parameter for facilitating national policy-makers to set up regulatory policies and development strategies, and for international institutions to monitor global and regional economic trends and the globalization process. Nevertheless, collecting, processing and reporting FDI data remains a major challenge for developing and developed countries alike, as well as for international organizations. Both the Organization for Economic Cooperation and Development (OECD) and International Monetary Fund (IMF) are internationally recognized as authoritative standard setters for FDI statistics.

5. Taxonomy of FDI: Vertical or Horizontal

**Vertical FDI** assures control of needed raw-materials to ensure uninterrupted supply at the lowest cost.

Vertical FDI involves a geographical decentralization of the firm's production chain, where foreign affiliates in low-wage countries typically produce labour-intensive intermediates that are shipped back to high wage countries, often to the parent company itself. Vertical FDI is sometimes referred to as “efficiency seeking” FDI, since the main motive for the investment is to improve the cost effectiveness of the firm's production. In the textile and clothing industry, for example, global supply chains are common. The capital-intensive stages (textiles) are located in relatively capital rich...
countries, human capital-intensive stages (design and up market apparel) are located in human capital rich countries, and labour-intensive stages (apparel) are located in labour abundant countries. Another industry where the production process can easily be separated into stages that differ in factor intensity is the electronics industry, which has played a major role in the industrialization of Malaysia. A particular category of efficiency seeking FDI is sometimes referred to as “technology seeking” FDI. The attraction of the location in this case is not necessarily the low cost of labour, but its unique competence. FDI from industrialized countries to the Bangalore district in India, often labelled the Silicon Valley of Asia, is presumably motivated both by cost efficiency and access to an advanced IT milieu. Indeed, India has the second largest stock of IT specialists in the world, only surpassed by the US.

**Horizontal FDI** enables the production of differentiated products that are also produced at home. Horizontal multinational companies produce the same product in multiple plants, and service local markets through affiliate production rather than through exports from the home country of the MNE. Most of the global FDI is horizontal. For instance, as little as 13 % of the overseas production of U.S.-owned foreign affiliates is shipped back to the United States, and only 2 percent of the output produced by foreign affiliates located in the US is shipped to their parents. Horizontal FDI is sometimes referred to as “market seeking” FDI. The advantage of being close to the customers may be due to factors such as reduced transportation costs, smaller cultural barriers or avoidance of tariffs. Some countries have used trade policy deliberately in order to attract foreign investment: By erecting high tariff barriers they have made it more profitable for foreign firms to set up local subsidiaries than to serve the market by export from other countries. For certain kinds of non-tradable services, such as real estate, hotels, retail trade, and part of the telecommunication, banking and financial sectors, there is no trade-off between trade and local production at all; market entry simply requires FDI or other contractual arrangements for local production. The importance of FDI in services has increased over time, accounting for more than 50 percent of total world FDI stocks in 1999, and an even higher share of FDI flows (63). Multinationals involved in the extraction or use of natural resources are yet another case of FDI where there is no alternative to the local presence of the firm. Endowments of oil, gas, minerals, forests and waterfalls may be the most important attraction for international investment in a number of poor countries.

**Greenfield versus acquisitions investment:** In addition to the horizontal and vertical dimensions of FDI, investments may also be classified as Greenfield Vs Acquisitions. A Greenfield investment involves the establishment of a new production unit, whereas an acquisition is the purchase of shares in an already existing foreign company. Most of the growth in FDI taking place in recent years has been in the form of acquisitions. Indeed, in 1999, acquisitions accounted for more than 80 % of global FDI. Between 60 and 80 % of FDI flows to developing countries, however, have been in the form of Greenfield investments during the period 1995–99. The past two or three decades have seen a significant policy shift in the developing world from inward-looking import substitution to outward-looking, market determined strategies. The reasons for this shift are complex, but mainly have to do with the inefficiencies of import substitution,
the growth of globalized production and the success of the export-oriented Asian newly industrialized economies (NIEs). One key feature of liberalization has been greater openness to foreign direct investment (FDI) as a means of acquiring technologies, skills and access to international markets, and of entering dynamic trade and production systems internal to multinational companies (MNCs).


Along with the decline of trade barriers, FDI flows and stock increased in the last 20 years, and have grown more rapidly than world trade and world output because of dramatic political and economic changes in many parts of the world.

As seen in Fig. 3, annual FDI flows increased fifteen-fold from about $55bn in 1980 to $1.4 billion in 2000 and increased to over $2 trillion in 2007. FDI soared not only in absolute terms but also in relative terms. Overall FDI flows accounted for about 3 percent of world-wide exports in 1980-1985. By 2000, the FDI/export ratio exceeded 15 percent. In other words, while exports remain the dominant form of corporate internationalization strategies, globalization through FDI has gained significantly in relative importance. However, FDI inflows fell 37 percent from 2008 to 2009 to $1.114 trillion. However, this amount still represents the 5th highest amount of cross border investment flows since data began to be recorded. It accounts for a whopping 11% of global GDP output and over 80 million jobs. In addition, early signs from the beginning of 2010 suggest there will be modest and uneven recovery in trillions by 2014 depending on data provided by WTO/UNCTAD, EIU and the author's calculations.

TNCs were faced simultaneously with the consequences of the global economic slowdown (and recession in a number of major economies), leading to falling market expectations, tighter credit conditions, reduced asset values following the stock market crash, and a slump in corporate profits. As a result, many TNCs announced plans to curtail output, lay off workers and cut capital expenditure, all of which affected FDI;
FDI flows are estimated to have declined by 15% in 2008 (UNCTAD, 2009). The setback in FDI has affected cross-border M&As in particular: their value fell sharply in 2008 following a record high the previous year. In addition, there has been a rising wave of divestments and restructurings (UNCTAD, 2009).

**Fig 4: Net capital flows to developing countries, 2000-2009 ($bn)**

Results from the 2009 World Investment Prospects Survey (WIP) point to a significant worsening of the situation in 2009: 57% of respondent companies reported that they expected their FDI expenditures to decline this year compared with 2008. Only 22% of respondents reported their intention to increase such expenditures in 2009 compared with more than 60% in mid-2008 (UNCTAD, 2008a). The WIPS Survey (2009) results help to identify some of the major reasons why companies plan to reduce their FDI: First, the financial crisis and economic downturn have both reduced the capability and propensity of firms to invest, especially abroad. Second, the crisis has created a climate of widespread concern about global risks and uncertainty, which acts as a strong deterrent to the implementation of ambitious FDI programmes. Third, companies willing to expand abroad might rely slightly more on non-equity modes such as partnerships and licensing in order to reduce their investment expenditures. The positive and even relatively high economic growth rates that still prevail in several developing countries (e.g., China, India) are also a countervailing force against low export demand and low commodity prices, which exert downward pressure on FDI. FDI inflows into developing countries are projected to fall in 2009, but should nevertheless remain relatively high overall, with expected net inflows of about $400 billion. In contrast, net flows of both portfolio capital and bank loans to developing
countries are expected to turn negative (Fig. 4). Of significance in the FDI Trends 2008/09 is that the increase in the number of projects though FDI flows declined. (OCO Global 2008/2009) The study notes:

- Excluding investments in the retail sector, 13,973 FDI projects were recorded in 2008, a 30% increase on the previous year’s 11,150 FDI projects.

- OCO Global (2008-2009) also noted that dominant source countries remain unchanged. More than two-thirds of the global FDI projects in 2008 came from the top ten source countries, eight of which were located in Western Europe and North America.

- USA was the top source country and the leading source of Software and IT services. Business and financial services also featured strongly.

- Given the current turbulence in the financial services sector, the question must be posed as to whether these trends are sustainable and in the coming year whether will there be such a high concentration of projects from so few countries?

- Early indications suggest that these will still be the key source markets, but in addition to project numbers falling globally, there will be a re-focus on those sectors which are generating the highest numbers, such as software and IT services, life sciences, and extractive industries.

7. The Determinants of FDI Flows

The relationship between foreign direct investment (FDI) and economic growth is a well-studied subject in the development economics literature, both theoretically and empirically. Recently, renewed interest in growth determinants and the considerable research on externality-led growth, with the advent of endogenous growth theories, made it more plausible to include FDI as one of the determinants of long run economic growth. The interest in the subject has also grown out of the substantial increase in FDI flow that started in the late 1990’s, and led to a wave of research regarding its determinants. With the development of globalization, foreign direct investment (FDI) is increasingly being recognized as an important factor in the economic development of countries. Although FDI began more than a century ago, the biggest growth has occurred in recent years. This growth resulted from several factors, particularly the more receptive attitude of governments to investment flows, the process of privatization and the growing interdependence of the world economy. In a nutshell, Exhibit 1 highlights advantages and disadvantages associated with Foreign Direct Investment for investment decisions.

There is early evidence in 2009 that M&A adding to FDI flows has started to recover. In March 2009, a survey of investor intentions by OCO Global indicated over half of investments planned for 2009 would be via M&A. This is particularly true for investor
targeting, given that more than two-thirds of the global FDI projects come from just 10 markets. The Economist Intelligence Unit (2007) identified the following forces (by rank order) in their survey that will have the greatest influence on global foreign direct investment over the next five years.

- Rising demand in emerging markets
- The state of the US economy
- Global outsourcing of service functions
- Increased investment flows originating from emerging market countries
- Geopolitical tensions
- Regional integration
- The state of the Euro area economy
- Increased emphasis on environmental issues
- Commodity price volatility
- Macroeconomic instability
- Rising protectionism
- The threat of terrorism
- Natural disasters/pandemics
- Anti-globalization movements

**Exhibit 1: Foreign Direct Investment: Advantages & Disadvantages**

<table>
<thead>
<tr>
<th>Advantages of Foreign Direct Investment</th>
<th>Disadvantages of Foreign Direct Investment</th>
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<tbody>
<tr>
<td>Offers the greatest potential rewards</td>
<td>Offers the greatest potential risks.</td>
</tr>
<tr>
<td>Cost effective and skilled labour in host country</td>
<td>Increases financial commitment and capital investment on initial outlays</td>
</tr>
<tr>
<td>Direct and better understanding of local market conditions, adapt products for market</td>
<td>Higher cost of travel and communications abroad.</td>
</tr>
<tr>
<td>Fewer local restrictions and can minimize red tape</td>
<td>Non familiarity with local business tax laws, business scene in general, and various government and legal regulations.</td>
</tr>
<tr>
<td>Avoids tariff and non- tariff barriers</td>
<td>Faces risks of exchange rate changes or fluctuations, ownership changes by government. Currency inconvertibility.</td>
</tr>
<tr>
<td>Secures access to raw-materials located in the host country. Protects market shares in exports if competitors also have established plants in the host country or region.</td>
<td>Differences in language, customs and culture.</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>Benefits of FDI</th>
<th>Challenges of FDI</th>
</tr>
</thead>
</table>
| Causes a flow of money into the economy to stimulate economic growth:  
  a. increased employment & skill base  
  b. expands long run aggregate supply/demand  
  Provides domestic producers incentive to be more efficient.  
  Host country government experiencing increasing levels of FDI will have a greater voice at international summits as their country will have more stakeholders  
  Acquisition of a firm in the host country helps acquire skilled personnel and other valuable resources.  
  The market imperfections approach to FDI is typically referred to as internalization theory.  
  Avoids import quotas and trade restrictions in favor of FDI projects.  
  Removal of trade restrictions among regional groups of countries also may attract direct investment.  
  Availability of raw materials, parts, resources and Just-In-Time manufacturing systems (JIT) lowers delivery time.  
  Financial (SEZ) & fiscal (duty concessions) incentives  
  Nationalism: purchase of locally produced goods provides rationale for a nation's pride.  
  Country-of-Origin effects: fear that service and replacement parts for imported products will be difficult to obtain when exporting only from home country  
  Technological know-how: enables a company to build a better product, improve its production process vis-à-vis competitors.  
  Marketing know-how enables a company to better position its products in the marketplace vis-à-vis competitors. Provides consumer benefits (price, quality, variety/choice)  
  Management know-how: enables a company to manage its assets more efficiently than competitors. | Higher costs in wages & benefits of going abroad paid to personnel and housing, etc.  
  Impact of inflation on business operations.  
  Domestic firms may suffer if they are relatively uncompetitive.  
  Increased FDI into one industry brings over-reliance which makes a country too dependent on it and it may turn into a risk.  
  Adverse effects may occur when BOP capital outflows are accompanied by quick profit remittances.  
  Unplanned rapid FDI inflows may result in environmental issues.  
  Large scale conspicuous investments bring political and financial risks.  
  Critics are concerned that the national interest of the host country may not be best served if a foreign firm makes decisions from home countries' headquarters.  
  Reluctance to transfer resources such as patents, trademarks, management know-how.  
  Home country rivals have access to acquired technology that can be used to their competitive advantage.  
  Pricing guidelines and/or foreign exchange regulations inhibit FDI.  
  Restrictions on investor market entry strategy.  
  Percentage restrictions on investments and ownership.  
  Product image suffers when manufacturing in a host country that has low-status for a product image.  
  Changes in comparative costs are a dynamic process subject to changing conditions. |
### Advantages of FDI

- Greater control of product marketing and strategy, better after market service for products.
- Lower costs of supplying firm's products; minimizes transportation & other costs yielding higher profits.
- Indirect incentives (Provides land and infrastructure at lower commercial prices).
- First mover advantage causes rivals to rethink market entry - Market potential & accessibility in host country/region (e.g., benefits from host country regional Free Trade Agreements/operations).

### Disadvantages of FDI

- Extra expenses incurred for management talent to train staff and managers in host country.
- Increased costs incurred when operations are to be coordinated among world-wide units.
- Delays due to government bureaucracy and local political demands.
- Higher investment costs than exporting from home country or other modes of entry.
- Political unrest accompanied by fear of expropriation by host country or may claim of ownership on firm's property.

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### 8. A look at top 15 countries: what makes them attractive to FDI are major location assets by country.

The following is the view of factors identified and presented in Fig 5 that favour the recent growth of FDI:

- (a) Presence of suppliers, partners and value added supply chains.
- (b) Follow competitors and gain comparative advantage. Important to have production facilities close to customer in target countries/region.
- (c) Availability of educational and English speaking talent.
- (d) Cost effective and skilled labour in host country.
- (e) Size of local market, especially emerging markets with large populations.
- (f) Access to international/regional markets via trade liberalization, trade promotion strategies/open markets.
- (g) Growth of market and prospects for domestic demand/consumption.
- (h) Access to natural resources and semi-finished components.
- (i) Access to capital markets (finance).
- (j) Political stability, Government effectiveness, administrative machinery and absorptive capacity.
(k) Financial incentives (Funds from local Government) Fiscal incentives (Exemption from Taxes, Import duties); and Indirect incentives (Provides land and infrastructure at low commercial prices).

(l) Quality of infrastructure, stable and business-friendly environment.

(m) Stable and business friendly environment.

9. Major FDI Location Assets by Country

Despite some common assets such as market growth and size, other location determinants differ quite significantly by country. Responses to WIPS 2009 indicate the most favourable location assets for the 15 most attractive countries for FDI as follows:

Major assets for the 15 most attractive countries for FDI are as follows:

1. For market size, the largest economies are favoured, either developed ones such as the United States, Germany and Canada, or emerging ones such as China, the Russian Federation and Brazil.

2. For market growth, developing and transition economies are generally favoured such as China, India, Brazil, the Russian Federation, Indonesia, Viet Nam, Poland and Thailand.

3. For access to regional markets, countries that are integrated into large markets, or which are close to large and growing economies are favoured such as Mexico, Germany, Viet Nam and Poland.
4. For presence of suppliers, mostly developed countries are favoured such as the United Kingdom, Germany and France, and, to a slightly lesser extent, some developing countries such as India.

5. For their business environment (including government effectiveness, stability and quality of infrastructure), developed countries such as the United States, Germany and Australia are favoured. France is frequently mentioned for the quality of its infrastructure.

6. For skills and talent, developed countries such as the United States, Germany, the United Kingdom and France are favoured, but also some developing countries, such as India and Thailand.

7. Cheap labour is cited for favouring developing countries, mostly in Asia, such as China, India, Viet Nam, Indonesia and Thailand.

8. For access to natural resources, countries well endowed such as Canada, Australia and Indonesia are favoured.

9. Access to capital markets is frequently mentioned as an asset for the United States, the United Kingdom and Canada.

10. Incentives is frequently mentioned for Australia, Vietnam and Brazil.

10. Major Location Determinants (WIPS 2009-2011)

In the 2009 WIP survey, as in last year’s, local market size and growth were the most frequently cited location determinants; they were indicated in 17% and 16% of total responses respectively. To this first category must be added access to international/regional markets, which ranks fourth with 10% of responses. In total, these market factors were mentioned, on average, 6 times by each respondent TNCs (Fig. 6).

**Fig 6: Locational criteria in order of importance, 2009-2011 (% of responses)**

Source: UNCTAD WIP Survey 2009
The set of factors contributing to the quality of the overall business environment comes clearly in second position. A significant number of TNCs mentioned “presence of suppliers and partners” (10%), “business friendly environment” (9%), “availability of skilled labour” (8%), “quality of infrastructure” (6%) and “government effectiveness” (5%) as location assets. This group of factors was mentioned, on average, 1.4 times by each respondent TNC. Other location determinants such as labour costs, presence of competitors, access to natural resources and to capital market were cited less frequently. This may be due to the fact that some of these determinants such as cheap labour or access to natural resources, generally apply only to some industries, not all.

11. A Strong Aversion to Uncertainty – FDI Risk Factors

In a period of crisis such as the present one, companies also face (or perceive) a high level of uncertainty. This may lead them to adopt risk-averse investment strategies, and prompt them to reduce their investments further. It is thus interesting to determine which kinds of risks are perceived by TNCs as having the greatest potential impact on their FDI prospects. To do so, two different dimensions of risk were analyzed separately:

(i) the probability of particular risks materializing; and the potential impacts of those risks, should they materialize, on investment plans (Fig. 7 and 8). Regarding the probability of given risks, TNCs were especially concerned about large exchange rates fluctuations, the price volatility of petroleum and raw materials, a worsening of the economic crisis and growing financial instability, as well as rising protectionism and price volatility in general. (ii) On the other hand, general risks such as war, geopolitical instability, or food and environmental crises were not perceived as very probable in the short term (Fig. 6). Respondent TNCs reported that among the risks considered the most likely to occur, those they believed would have the strongest potential impacts were: a worsening of the economic crisis and increased financial instability. Consequently, they viewed these, overall, as the greatest threats to FDI plans (Fig. 7, 8).

![Fig 7: Most likely risks & potential impact on companies' decisions (avg. esp's)](attachment://image.png)

*Source: UNCTAD survey.*
*Note: Probability on a scale of 0 (not probable) to 4 (very probable); impact on a scale of -2 (very large negative impact) to +2 (very positive impact).*
The EIU survey responses presented in Fig. 9a & 9b identify significant constraints by companies’ responses to invest in developed markets and emerging markets respectively.

Source: UNCTAD survey.
Note: -4 = large negative impact very probable; 0 = negligible impact very probable.
12. Greater recourse to non-equity entry modes

The current crisis is compelling companies to undertake cost cutting measures as much as possible, including investments. This may explain why respondents to 2009 WIPS reported that they intended to reduce slightly their use of equity investments (i.e., M&As and Greenfield projects) as an internationalization mode, preferring instead non-equity modes such as licensing, outsourcing or other types of partnerships, and agreements (Fig. 10).

A survey by PricewaterhouseCoopers also points to greater caution among CEOs with regard to undertaking M&As while their interest in joint ventures is rising.

Geographical Trends - Inward FDI: divergent trends against the backdrop of crisis

Despite the impact of the global financial and economic crisis on host economies in South, East and South-East Asia and on the major home countries of TNCs investing in the region, total FDI inflows to the region in 2008 still rose by 17%, reaching $300 billion. As many as 14 countries saw a rise in inflows. Part of this increase was due to the growth in cross border M&As. (WIR PG 50). Foreign Investment and sustainable development: lessons from the Americas are cited in the Working Group on Development and the Environment in the Americas 2008. The report is the product of a series of studies conducted by development and environmental economists from the U.S., Mexico, Brazil, Argentina, Chile, and Costa Rica. Drawing on case studies from across the region-Argentina, Brazil, Bolivia, Chile, Costa Rica, Ecuador, Mexico, Uruguay, and Venezuela - the Working Group examined how foreign investment during the reform period has affected economic growth, environmental policy and performance, and the countries’ political economy.
13. Sectoral Trends

(i) Inward FDI: services and manufacturing continued to be targeted. In 2008, FDI directed towards the services sector in South, East and South-East Asia continued to increase, as also reflected in the rising value of cross-border M&A sales in that sector (Fig 11).

**Fig 11: Investment preferences by host region, 2008-2011 (Avg. value responses)**

In the NIEs, a major part of their cross-border M&As continued to be in services, although in late 2008, and particularly in early 2009, they fell sharply in banking. This is because banks and private equity firms based in the United States as well as Europe are not able to invest any more, and have even started to divest due to the difficulties they face at home. In China and India, FDI growth was significant in such services as infrastructure and retail. For example, following its global competitors such as Metro AG (Germany), Wal-Mart Stores (United States) opened its first store in India in 2008, and plans to open 15 more over the next few years. Cross-border M&A sales in the region increased in the manufacturing sector while they declined in the primary sector in 2008. Investment in pharmaceuticals was noteworthy, including two acquisitions of Ranbaxy Laboratories Ltd (India) by Daiichi Sankyo Co Ltd. (Japan) for $5 billion. Manufacturing still accounts for about half of inflows to China, and more inflows are targeting high-tech industries. However, the country now faces fierce competition from low-income countries in South and South-East Asia in attracting FDI in labour-intensive production. How to tackle the impacts of the “hollowing out” of the production base, while also upgrading to high-end industries and high-value-added activities has become a challenge for a number of China’s coastal provinces such as Guangdong. In India in 2008, FDI in industries such as steel continued to increase, including from Western steelmakers, as well as from Chinese metal companies (Minmetals and Xinxing for instance). In the steel industry, Formosa Plastics Corporation (Taiwan Province of China) started to invest in an $8 billion plant in Viet Nam. In the electronics industry, leading companies such as Foxconn (Taiwan Province of China) and Samsung (Republic of
of Korea) are also investing in several multibillion dollar projects in Viet Nam. All of these investments were through Greenfield projects, rather than acquisitions.

**Fig 12: South, East and South-East Asia: FDI inflows, by value and as a percentage of gross fixed capital formation, 1995-2008**

Source: UNCTAD FDI/TNC Database

### 14. The Rise of South-South FDI

China and Hong Kong (China) remained the two largest FDI recipients in the region (as well as in developing economies as a group) while flows to India – the largest recipient in South Asia – and to most of the member states of the Association of Southeast Asian Nations (ASEAN) increased considerably (Fig. 13). Prospects for FDI to the region remain promising despite concerns about the impact of the financial crisis facing business outlook.

FDI inflows to East Asia, South-East Asia and South Asia in 2008 amounted to $187 billion, $60 billion and $52 billion respectively (Fig. 14). In 2007, the rate of growth of inflows to the three sub regions was quite similar, but in 2008 growth rates varied considerably: 49% in South Asia, 24% in East Asia, and 14% in South-East Asia. The performance of major economies in the region in attracting FDI also varied significantly. Inflows to the two largest emerging economies, China and India, continued to increase in 2008 (Fig. 13). Among the four Asian NIEs, inflows to the Republic of Korea boomed and they continued to grow in Hong Kong (China), but they declined sharply in Singapore and Taiwan Province of China. In Malaysia and Thailand, FDI inflows fell slightly. A number of other South-East Asian countries, including Indonesia and Viet Nam, have demonstrated a capacity to maintain growth in FDI, despite the crisis. One of the striking features of FDI flows to the region during the past few years has been the steadily growing importance of China and India as host economies. With its inflows surging to a historic high ($108 billion) in 2008 (Fig 13), China became the third largest FDI recipient country (after the United States and France) in the world. India ranked 10 places behind, but was catching up. And these two largest emerging economies ranked
numbers one and three, respectively, as the most preferred FDI locations in UNCTAD’s *World Investment Prospects Survey 2009–2011*. Their strong performance, even during the current crisis, has reshaped the landscape of FDI flows to the region as well as to the world at large. “A New Geography of Innovation—China and India Rising” by Bruche and “While global FDI falls, China’s outward FDI doubles” by Davis is evidence of new emerging country investment outflows. Fig 14 shows China, followed by India and ASEAN -4 along with Korea and Taiwan, among the top 10 sources of FDI inflows South, East and South-East Asia who are also among the top 10 recipients of this region (Fig 13).

**Fig 14: South, East and South-East Asia: Top 10 recipients of FDI inflows, 2007-2008 (US$ bn) billions**

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics) annex table B.1

*Ranked by the magnitude of 2008 FDI inflows.*

15. Foreign Direct Investment & Economic Growth

Recent theoretical and empirical literature suggests that foreign direct investment (FDI) exerted a positive impact on economic growth through the process of technological diffusion. The literature also suggests that the development of the domestic financial system of the host country is an important pre-condition for FDI to have a positive impact on economic growth. The vast literature on foreign direct investment and multinational corporations has been surveyed many times. Many policy makers and academics contend that foreign direct investment (FDI) can have important positive effects on a host country’s development effort. In addition to the direct capital financing it supplies, FDI can be a source of valuable technology and know-how while fostering linkages with local firms, which can help jumpstart an economy. Based on these arguments, industrialized and developing countries have offered incentives to encourage foreign direct investments in their economies. Within policy circles, there is a widespread belief that foreign direct investment (FDI) enhances the productivity of host countries and promotes economic development. This notion stems from the fact that FDI may not only provide direct capital financing but also create positive externalities via the adoption of foreign technology and know-how. However, a country’s capacity to take advantage of FDI externalities might be limited by local conditions.
such as the development of local financial markets or the educational level of the
country, i.e., absorptive capacities. Borensztein, et.al. show that FDI brings technology
that translates into higher growth only when the host country has a minimum threshold
of a stock of human capital. Alfaro, Chanda, Kalemli-Ozcan and Sayek provide evidence
that only countries with well-developed financial markets gain significantly from FDI
in terms of their growth rates.

FDI has many benefits for emerging economies as it ultimately promotes economic
growth and employment through technology transfer and domestic enterprise
development. It forms an integral part of an open and effective international economic
system, provides a major source of external finance, and is a useful means of integrating
into the global marketplace. All of these contribute to higher economic growth, which
is the most effective tool for alleviating poverty in developing countries. Furthermore,
increased FDI inflows reflect growing confidence in the business climate of a country
as seen in the classification of nations in the Competitiveness study. Potential drawbacks
of FDI includes the effects on competition in national markets, potential lack of positive
linkages with local communities and the deterioration of the balance of payments as
profits are repatriated. The largest drawback, especially in emerging economies, is the
inability to take advantage of the technologies and know-how transferred through
FDI.

The liberalization process of developing and transition countries in the 1980s and
1990s has been accompanied by an exponential increase in Foreign Direct Investment
(FDI) inflows. The interest of developing countries in attracting FDI is based on the
belief that FDI contributes importantly to economic growth and to the overall
development of the host country. Theoretical arguments state that FDI contributes to
economic growth both directly—through the accumulation of capital and technological
know-how—and indirectly—through technology and knowledge spillovers to domestic
firms in the host economy. The empirical results vary largely across countries, sectors
and firms. This indicates that the impact of FDI is very heterogeneous and conditional.
on factors such as the type of FDI, the economic sector, and the absorptive capacity of the host economy. It seems that FDI can under some conditions be an engine of economic growth. Furthermore, FDI can contribute to poverty-reduction in the long run through an economic growth-impact, employment creation, wage pressure and increased tax revenues - although also here the effect is heterogeneous. The impact of FDI on the inequality between countries is unclear with mixed empirical evidence. Within a country, it seems likely that FDI increases inequality in the short run. However, when directed towards less skill-intensive sectors and the poor groups of society – for example, FDI in agri-business in rural areas – FDI can reduce inequality. Also on gender inequality, the evidence is mixed. With respect to human rights, labour standards and the environment, FDI seems to create a ‘race to the top’ rather than a ‘race to the bottom’. FDI is thus not a simple solution for enhancing growth. But when the conditions are right, it can provide an important contribution to human development.

In recent times, developing countries, especially in Africa, see the role of foreign direct investment as crucial to their development. FDI is seen as an engine of growth as it provides the much needed capital for investment, increases competition in the host country industries, and aids local firms to become more productive by adopting more efficient technology or by investing in human and/or physical capital. Foreign direct investment contributes to growth in a substantial manner because it is more stable than other forms of capital flows. The benefits of FDI include serving as a source of capital, employment generation, facilitating access to foreign markets, and generating both technological and efficiency spillover to local firms. It is expected that by providing access to foreign markets, transferring technology and generally building capacity in the host country firms, FDI will inevitably improve the integration of the host country into the global economy and foster growth. FDI is seen as “a key driver of economic growth and development. FDI not only boosts capital formation but also enhances the quality of capital stock. Developing regions of the world needs substantial inflows of external resources in order to fill the saving and foreign exchange gaps and leapfrog itself to sustainable growth level in order to eliminate its current level of poverty.” With the exception of a few countries (Sun 2006), the vast majority of the fast growing economies relied heavily on FDI to jump-start and sustain their rapid economic transformation. As a result of the potential role of foreign direct investment in accelerating growth and economic transformation, many developing countries in general and Africa in particular, seek such investments to accelerate their development efforts. Promoting and attracting FDI have therefore become an important component of development paradigm strategy for developing countries.

Thus the relationship between foreign direct investment (FDI) and economic growth is a well-studied subject in the development economics literature, both theoretically and empirically. Recently, renewed interest in growth determinants and considerable research on externality-led growth, with the advent of endogenous growth theories, made it more plausible to include FDI as one of the determinants of long run economic growth. The interest in the subject has also grown out of the substantial increase in FDI flows that started in the late 1990’s, and led to a wave of research regarding its determinants. Also, recognizing the importance of FDI to growth, economic growth
itself has been identified frequently as an important determinant, from among the various determinants, of FDI inflow into the host countries. Rapid growth of an economy might attract more FDI by multi-national companies (MNCs), as they locate new profit opportunities. The findings by Xiaohui Liu; Chang Shu; and Peter Sinclair suggest that export expansion, import liberalization, FDI inflows and inward M&As are integral elements of the growth process in Asian economies (in trade, foreign direct investment and economic growth in Asian economies). Har Wai Mun, Teo Kai Lin, and Yee Kar Man identify foreign direct investment as having continued to play a significant role in Malaysia’s economy “Foreign direct investment (FDI) has been an important source of economic growth for Malaysia, bringing in capital investment, technology and management knowledge needed for economic growth.”

16. Complementarities of Trade and FDI in the Context of Sustainable Economic Growth

According to the World Bank, economic growth measures quantitative change or expansion in a country’s economy. Economic growth is conventionally measured as the percentage increase in Gross Domestic Product (GDP) or Gross National Product (GNP) during one year. Economic growth comes in two forms: an economy can either grow “extensively” by using more resources (such as physical, human, or natural capital) or “intensively” by using the same amount of resources more efficiently (productively). When economic growth is achieved by using more labour, it does not result in per capita income growth. But when economic growth is achieved through more productive use of all resources, including labour, and productivity increases, it results in higher per capita income and improvement in people’s average standard of living. Positive trends over time have resulted in sustainable economic growth. The globalization of world markets has been accompanied by the rapid growth of FDI by small and medium-sized firms accompanied by an increase in entrepreneurial enterprises. However, the dominance of MNCs/TNCs point to the complementarity of trade and foreign direct investment (FDI) in the context of sustainable economic growth, as seen by:

1. Multinational companies, traditional exporters and investors, send substantial exports to their foreign facilities;
2. About 1/3 of world trade is intra-firm trade among MNCs and their affiliates established under FDI;
3. Many of the exports from parent MNC/TNC to subsidiaries would not occur if overseas investment did not exist. In these cases, factor movements stimulate trade rather than substituting for it;
4. The globalization of world markets has been accompanied by the rapid growth of FDI by small and medium-sized firms and entrepreneurial enterprises in addition to traditional MNCs;
5. Globalization has advanced FDI as a strategic foreign market entry mode aiding growth;
6. Globalization of the world economy has raised the vision of firms to realize the entire world as their market;

7. Beyond export-led growth, the key to sustainable economic growth is investment, which comes from: savings, retained earnings, gifts/grants/foreign aid, investments (FDI).

17. Absorptive Capacity – A Pre-Condition for FDI Inducement for Economic Growth

A pre-requisite condition as well a concurrent infrastructure development is absorptive capacity as a necessary condition for FDI attraction and implementation of projects especially in newly developing countries. How does the nature of location advantages determine the ability of the domestic economy to absorb spillovers from FDI? As almost all the articles illustrate, the presence of externalities does not mean either that the domestic economy can internalize them, or that the externalities are significant in quantity or quality. Absorptive capacity is significant for development because it allows domestic actors to capture knowledge that exists elsewhere. Where absorptive capacity is lacking in domestic firms, they may, instead of reaping technological benefits from FDI, be ‘crowded out’. Capabilities in the host country context matter for the magnitude and intensity of technological upgrading. Borensztein et al. show that, at country level, a minimum threshold of absorptive capacity is necessary for FDI to contribute to higher productivity growth.

At the firm level, Narula and Marin show that only firms with high absorptive capacity are likely to benefit from FDI spillovers. Xu also shows that a country needs to reach a minimum human capital threshold level in order to benefit from technology transfer. While insufficient absorptive capacity tends to lead to the inefficient use of technology inflows, knowledge accumulation is much more rapid once the threshold level of absorptive capacity is crossed. Essentially, technology absorption is easier once countries have ‘learned-to-learn’. “The cost of imitation increases as the follower closes the gap with the leader and the number of technologies available for imitation falls. This implies that there are diminishing returns on marginal increases in absorptive capacity as firms approach the frontier of knowledge. Kokko highlights the role of past industrialization experience as a precondition for technology transfer. The absence of such experience is concomitant to lack of local absorptive capacity. The development of capacities and capabilities is key to both attracting FDI as well as to increasing MNE technological spillovers. Narula decomposes absorptive capacity into four constituent parts: firm-sector absorptive capacity, basic infrastructure, advanced infrastructure and formal and informal institutions. “Each is indispensable and each has different costs and benefits at different stages of development. Increases in absorptive capacity at earlier stages of development are associated with ‘generic’ basic infrastructure and increases in technological capacity generally have positive welfare effects. For example, increases in the percentage of population with primary and secondary education have numerous welfare benefits, as does the provision of infrastructure. Investment in such resources has large multiplier effects.
18. The Case of Sri Lanka: FDI & Economic Growth Potential

FDI investment, despite the shocks during most of the past three decades, has increased Sri Lanka’s industrial output and growth capacity. Following the end of the civil war in Sri Lanka, foreign investors have been showing renewed interest in the last few months. As an FDI International Promotion Agency, The BOI of Sri Lanka is structured to function as a central facilitation point for investors and has acted as an engine of growth creating a considerable impact on the country’s economic development. Free trade zones and industrial parks, numbering 12, have been the linchpin of economic development and inflow of foreign direct investment into Sri Lanka. The country’s free trade zones are seen as benchmarks of successful implementation of zone development strategies. The BOI 2008 data cites 1989 projects, with investment of $889 million (Rs.96, 268 million) and generating employment of 458,165. BOI states companies today account for nearly 70% of Sri Lankan exports and 80% of the country’s industrial exports. FDI inflows increased to $752 million in 2008 from $603 million in 2007 bringing the FDI inward stock to $4,283 million (Fig 10b) based on UNCTAD estimates, cited by CBSL, Aug 2009. According to Indian Reality News (Dec 4.2009), in 2008, Sri Lanka attracted a total FDI of $889 million out of which India’s contribution was $126-million. “Last year, out of the $126-million FDI which came from India, a major share of around $100 million came from Bharti Airtel,” India’s largest mobile operator. Bharti Airtel has started its mobile services in Sri Lanka under the Airtel brand, and a total investment of $200 million in 2012 in Sri Lanka.

**Fig 15: Sri Lanka’s Stage of Development**

Source: 2009 World Economic Forum [Sri Lanka outer connecting]
According to the Central Bank, in 2009 the realized FDI including loans decreased to $691 million from a high of $889 million in 2008, partly to the global economic and financial crisis. FDI inflows mainly from China, the UK and India came for telecom, power and energy sectors. The net FDI inflows declined to $581 million in 2009 from $827 million recorded in 2008 due to adjustments in FDI projects approved in previous years following the impact of the global economic crisis.

As portrayed in the Global Competitiveness Report 2009, and shown in Fig, 15, the stage of development of Sri Lanka is still in the initial stage of factor-driven and considering the 9th pillar of Competitive Advantage: Sri Lanka technological readiness for FDI and technology transfer has a rank of 9/133, India (also factor-driven) 19/133, Malaysia (efficiency-driven) rank 8/133 Thailand (efficiency-driven) 50/133. More significantly, Fig15b identifies the most problematic factors of doing business in Sri Lanka that certainly impacts on attracting FDI and very well account for lower FDI flows from the neighboring developing economies. Balamurali & Bogahawatte 2004 examined the relationship between FDI and GDP in Sri Lanka using data from 1977-2003. The results indicated that FDI is a key determinant of Sri Lankan economic growth after the 1977 liberalization period, and the study appears to support the impact of foreign direct investment on GDP growth of Sri Lanka. This finding confirms the relevance of the economic reform programmes in Sri Lanka to reduce macroeconomic instability, remove economic distortions, promote exports and restore sustainable domestic investment for economic growth. In the long term, Sri Lanka needs to boost its human capital and improve its labour market, infrastructure and administrative capabilities to induce higher investment - the traditional absorptive capacity concerns.

In Sri Lanka, FDI has increased dramatically since the 1980s. Many studies find a positive link between FDI and growth to conclude that the importance of FDI cannot be overstated. As a result, “the investment climate in the country must be improved through appropriate measures such as de-regulation in economic activity, increased domestic serving, developing the port network, road network, railways and telecommunication facilities, etc. creating more transparency in the trade policy and more flexible labour markets and setting a suitable regulatory framework and tariff structure”. P. Athukorala & S. Jayasuriya in their paper on “Complementarity of Trade and FDI Liberalization in Industrial Growth: Lessons from Sri Lanka” examined the industrialization experience in Sri Lanka following the market-oriented policy reforms initiated in 1977, with emphasis on the complementarity of trade and foreign direct investment (FDI) policies in shaping the reform outcome and concluded that “the Sri Lankan experience highlights the complementary role of investment liberalization for exploiting the potential gains from trade liberalization. This industrialization outcome is particularly impressive given that it occurred during a period of persistent civil strife and macroeconomic instability”. The paper adds, “Interestingly, the Sri Lankan experience over the past two decades has clearly demonstrated that an outward-oriented policy regime can yield a superior industrial outcome compared to a closed-economy regime, even under severe strains of political and macroeconomic instability.”
Judged by the 2009 Global Competitive Index, Sri Lanka is at the 79th position, down two places, and the gap with the other countries of the region is widening. On the other hand, the EIU 2010 forecast identifies Sri Lanka (6.3%) and India (6.3%) at 8th and 9th positions respectively, ranked ‘top growers’ among the top 12 countries, headed by Qatar (GDP growth at 24.5%) followed by China (8.6%). Of special significance is the attention to improvements in problematic factors (Fig 15b), the 12 pillars of...
competitiveness and absorptive capacity by policy makers and business alike. With the end of the 25-year-old war and a modest peace dividend, inward investment is expected to drive economic growth to 6.3% (# The Economist: The World in 2010). These are pre-requisites to attract FDI as an inducement for economic growth and move Sri Lanka into the efficiency-driven stage of development (Fig 15) and meet the pre-conditions as other competing emerging nations for long-term sustainable growth.

Fig 15b: Most Problematic Factors for Doing Business in Sri Lanka

19. Explanatory Note on Sri Lanka’s Stage of Development (Fig.15): Comparison of Sri Lanka and factor driven economies’ average scores across the 12 pillars of the GCI (79)

WEF/GCR (2009) defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. The concept of competitiveness thus involves static and dynamic components: although the productivity of a country clearly determines its ability to sustain its level of income, it is also one of the central determinants of the returns to investment, which is one of the key factors explaining an economy’s growth potential. According to the WEF/GCI (2009), “in the first stage, the economy is factor-driven and countries compete based on their factor endowments: primarily unskilled labor and natural resources. Companies compete on the basis of price and sell basic products or commodities, with their low productivity reflected in low wages. Maintaining competitiveness at this stage of development hinges primarily on well-functioning public and private institutions (Pillar 1), well-developed infrastructure (Pillar 2), a stable macroeconomic framework (Pillar 3), and a healthy and literate workforce (Pillar 4). As wages rise with advancing development, countries move into the efficiency-driven stage of development, when they must begin to develop more efficient production processes and increase product quality. At this point, competitiveness is increasingly driven by higher education and training (Pillar 5), efficient goods markets (Pillar 6), well-functioning labour markets.
(Pillar 7), sophisticated financial markets (Pillar 8), a large domestic and/or foreign market (Pillar 10), and the ability to harness the benefits of existing technologies (Pillar 9). Finally, as countries move into the innovation-driven stage, they are able to sustain higher wages and the associated standard of living only if their businesses are able to compete with new and unique products. At this stage, companies must compete through innovation (Pillar 12), producing new and different goods using the most sophisticated production processes (Pillar 11). The concept of stages of development is integrated into the Index by attributing higher relative weights to those pillars that are relatively more relevant for a country given its particular stage of development. That is, although all 12 pillars matter to a certain extent for all countries, the relative importance of each one depends on a country’s particular stage of development.

The Case of CHINDIA: In addition to attracting progressively increasing FDI inflows with advancing economic growth, China and India have become important sources of outward investment from the region (Fig 14). Their share of total regional outflows rose from 23% in 2007 to 37% in 2008. Despite the global crisis, FDI from China, in particular, surged, reaching $52 billion in 2008, 132% up from 2007, and its outflows continued to grow in early 2009. The country ranked thirteenth in the world as a source of FDI and third among all developing and transition economies. Many large Chinese TNCs are driven to invest abroad by their need to secure access to natural resources (such as oil, gas and mineral deposits) and created assets (such as technologies, brand names and distribution networks). Moreover, significant exchange rate fluctuations and falling share prices abroad as a result of the crisis might have created good opportunities for them to buy bargain assets. In contrast, FDI outflows from other major economies in the region slowed down in 2008. Outflows from all four Asian NIEs declined by 2% in Hong Kong (China), by 7% in Taiwan Province of China, by 18% in the Republic of Korea, and by a massive 63% in Singapore (with outflows amounting to $60 billion, $10 billion, $13 billion and $9 billion, respectively) (Fig 14). This caused their share of total outward FDI from the region to decline from 64% in 2007 to 49% in 2008. The Asian NIEs have been hit particularly hard by the crisis, and their relative significance in the region’s outward FDI is continuing to decline, as suggested by the fall in their cross-border M&A purchases in the first half of 2009.

20. New Developments in FDI Policies

UNCTAD’s 2008 survey of Changes to National Laws and Regulations related to FDI indicates that 110 new FDI-related measures were introduced by a total of 55 countries. Of these, 85 measures were more favourable to FDI. Compared to the previous year, the percentage of less favourable measures for FDI has remained unchanged and stands at 23 %.

From a regional perspective, South, East and South-East Asia and Oceania had the highest share of regulatory changes (25 %), followed by developed countries (20 %). In all regions, the number of changes more favourable to FDI clearly exceeded those that were less favourable. They accounted for 75 % of the 16 measures adopted in
Africa, 79 % of the 28 measures adopted in South, East and South-East Asia and Oceania, 80 % of the 15 measures adopted in the Commonwealth of Independent States (CIS), 91 % of the 22 measures in the developed countries, 55 % of the 20 measures adopted in Latin American countries.

21. FDI Investment policy developments in G-20 countries

An UNCTAD review of national and international investment policy developments taken by G-20 member States (including EU members) shows that in response to the crisis, these countries have mostly refrained from taking policy measures that are restrictive towards foreign inward and domestic outward investment. Overall, recent policy developments paint a comforting picture. However, economic stimulus packages could give rise to “covert” protectionism (i.e., using gaps in international regulations to discriminate against foreign investors and products). Furthermore, protectionist pressures could still arise from the spreading of the crisis to less-affected economic sectors and countries, and a new wave of economic nationalism could occur in the aftermath of the crisis, when the exit of the State from bailed out flagship industries might lead to the protection of “national champions” from foreign takeovers. This UNCTAD review is intended to contribute to a joint effort by WTO, UNCTAD, OECD and IMF to respond to the April 2009 G-20 Leaders’ request for quarterly reporting on their adherence to an open trade and investment regime and avoidance of a retreat into protectionism. The summit called upon international bodies to monitor and report publicly on G-20 members’ adherence to this pledge. One uncontroversial truth is that virtually all countries value FDI as a means to advance their economic development.

22. FDI Trends and Characteristics – Revisited 2009-11

- After a brief retrenchment, cross-border mergers and acquisitions (M&As) will continue to drive global FDI. The US and the EU15 (inclusive of intra-EU inflows) will continue to dominate as recipients of world FDI.

- Despite growing protectionist sentiment, the US is expected easily to retain its position as the world’s leading FDI recipient in 2007-11.

- Among emerging markets, China will remain by far the main recipient, with almost 6% of the global total and 16% of projected inflows into emerging markets.

- There is likely to be some acceleration of the relocation of labour-intensive manufacturing to emerging markets, although this is unlikely to be as dramatic as many observers hope or fear.

- The off-shoring of services will accelerate—which will also feed protectionist sentiment, although this form of internationalization is accompanied by relatively modest capital flows.
Investment by traditional TNC companies is likely to continue to gain in importance.

In 2008 global FDI fell by around 20%, while outward FDI from China alone nearly doubled. This disparity is likely to continue in 2009 and 2010 as China invests even more overseas, for 2008 saw a rise to US$40.7 billion. The vast majority of recorded outward FDI from China is from large state-owned enterprises (SOEs) (84% of both stocks and flows). In 2009 with nearly US $2 trillion in foreign-exchange reserves, a current-account surplus forecast by the OECD to rise to 11.7% of GDP in 2009 and no credit crunch, China can afford large investments overseas. Chinese multinationals can snap up companies on the cheap to acquire market share and brands in the developed world.

India has been a supplier of intellectual property services and components for global product innovators like Motorola, GE. Philips, among others, unfolding of the Tata Nano, a modern technology car. Outbound FDI from India has reached close to $35 billion in 2008. India is now a major source of FDI projects globally and one of the leading investors in the UK. With GDP growth rates in 2009 from 6.5% to 7%, it continues to be the second fastest growing of all the global economies.

Another key pool of potential FDI consists of firms headquartered in emerging markets. FDI outflows from these economies have risen considerably over the past 25 years, from negligible amounts at the beginning of the 1980s (according to Economist Intelligence Unit 2007, estimates), to US$160bn in 2005 and US$210bn in 2006. An estimated, 20,000 MNCs are now headquartered in emerging markets. Some prominent examples include:

(a) US$1.25bn acquisition by Lenovo (China) of the personal computer (PC) division of IBM (US) in 2005;

(b) Takeover by CVRD (Brazil) of INCO (Canada) in 2007, for US$16.7bn; and (c) Successful bid by Tata (India) for Corus (UK/The Netherlands) for US$13.5bn in 2007.

Amidst a sharpening financial and economic crisis, global FDI inflows fell from a historic high of $1,979 billion in 2007 to $1,697 billion in 2008, a decline of 14%. The slide continued into 2009, with added momentum: preliminary data for 96 countries suggest that in the first quarter of 2009, inflows fell a further 44% compared with their level in the same period in 2008. A slow recovery is expected in 2010, but should speed up in 2011. The crisis has also changed the investment landscape, with developing and transition economies’ share of global FDI flows surging to 43% in 2008. This was partly due to a concurrent large decline in FDI flows to developed countries (29%). With regard to the mode of investment, Greenfield investments were initially more resilient to the crisis in 2008, but were hit badly in 2009. On the other hand, cross-border M&As have been on a continuous decline, but are likely to lead the future recovery.
UNCTAD, *World Investment Prospects Survey 2009–2011*, also shows that the developed economies of North America and the EU-15 – which still host the largest proportion of world FDI flows and stocks – have so far been the hardest hit by reductions in TNCs’ investment plans. Roughly 47% of respondents reported that their investment plans in North America (the United States and Canada) have been cut due to the crisis, and another 44% indicated the same for the EU-15. WIPS also shows that among developing host regions, the sub regions of East and South-East Asia are the most adversely affected by the crisis (35% of respondents), though to a lesser degree than developed countries. In developing countries, M&A activity remained strong in 2008, with 41 mega deals concluded – six more than in 2007. In Africa and Asia, TNCs expanded their M&A transactions, which contributed to their overall rise by 13% in 2008 and as the global economy begins its recovery, FDI mergers and acquisition activity show signs of increase into 2010-11.

**23. FDI Prospects: The Forecast is 2009 Decline and 2010-2011 Renewed Growth**

Global FDI prospects are set to recover slowly in 2009, with inflows expected to around $1.4 trillion. However, recovery of these flows is expected to reach about $1.6 trillion in 2010, and will gather momentum in 2011 when the level could approach an estimated $1.9 trillion or above the peak levels of 2007. There are a number of reasons to be optimistic about the medium-term prospects for FDI. These include: (a) the ongoing global trend towards better business environments, (b) technological change, (c) the search for competitively priced skills; (d) and sharper global competition pushing companies to seek lower-cost destinations. But macroeconomic, regulatory and geopolitical risks will constrain flows in addition to concerns that FDI protectionism may increase significantly in most emerging-market regions. In 2008 and the first half of 2009, despite concerns about a possible rise in investment protectionism, the general trend in FDI policies remained one of greater openness, including lowering barriers to FDI and lowering corporate income taxes. UNCTAD’s annual *Survey of Changes to National Laws and Regulations* related to FDI indicates that during 2008, 110 new FDI-related measures were introduced, of which 85 were more favourable to FDI. Compared to 2007, the percentage of less favourable measures for FDI remained unchanged. On balance, most host and home governments will continue to encourage FDI and discourage FDI protectionism.

Beyond EIU, and WIPS reports, various other studies also point to a climate of widespread pessimism among business executives. *12th Annual Global CEO Survey*, released in January 2009, showed a dramatic fall in respondents’ confidence level as compared to last year, with only 34% of the CEOs expressing optimism about their growth prospects for the three years ahead – the lowest level since the survey began in 2003. According to the latest *CESifo World Economic Survey*, released in May 2009, the assessment of the current world economic situation by respondents fell to another record low in the 2nd quarter of 2009, although expectations for the second half of 2009 showed some signs of improvement. Responses to WIPS also suggest that FDI
might begin to recover slightly in TNCs’ plans for 2010, and that this trend could gain momentum in 2011. Two main factors explain this positive evolution. First, WIPS respondent companies were fairly optimistic with regard to the evolution of their global investment environment by 2011. Second, they seemed committed to increasing their presence overseas in the medium term.

Developed-country TNCs are dominant in the upstream (suppliers) and downstream (processors, retailers, traders) ends of the agribusiness value chain. In agricultural production, FDI from the South (including South-South flows) is equally significant as FDI from the North. In terms of the countries that attract FDI the most, results from WIPS were largely in line with the results of previous years, and with surveys carried out favoured investment locations continue to be topped by China, followed by the United States, and India. By and large, the results of a survey conducted by Ernst & Young in 2009, which found China and India the most attractive regions for the coming three years. A survey of Japanese manufacturing TNCs conducted by the Japan Bank for International Cooperation also found China, followed by India, the countries over the coming three years. According to WIPS, TNCs are mainly interested in these countries due to the long-term potential growth of their markets and, to a lesser extent, availability of cheap labour. The outlook for global FDI seems quite grim in the short term due to the impact of the ongoing economic and financial crisis. However, a strong commitment by the largest TNCs to expanding their operations abroad, as well as their relative optimism for the medium-term evolution of their business environment, leaves open the possibility for a rebound in FDI by 2011.

24. Conclusion

In the final analysis, FDI advantages outweigh the disadvantages and serve as a catalyst to expand a country’s competitive advantage, image, visibility, and viability and attract technologies for sustained economic growth. International trade and FDI foster better bilateral and multilateral co-operation among nations, resulting in improving standards of living. FDI supported export-led projects have become a strategic international trade tool to look beyond exporting, and other modes of foreign market entry to advance economic progress, alleviate poverty, create employment opportunities, and peaceful co-existence in an integrated global economy. A prima facie indication is that most of the successful emerging market countries of yesterday and of today, BRICKS, have adopted strategies and incentives to attract FDI for advancing economic growth.

This paper has cited the findings of reports and surveys by UNCTAD WER, WIPS, IMF/WEO, EIU, OECD, and OCA, which are also references for further study. As results of this year’s surveys cited in this study confirm, the global economic and financial crisis has had a strong negative impact on TNCs/MNCs’ international investment plans affecting FDI flows. Respondent TNCs/MNCs expect a significant decline in their FDI in 2009, regardless of the home region, and for virtually all industries. However, the surveys also show that TNCs/MNCs expect a progressive recovery of FDI, starting slowly in 2010 and gaining momentum in 2011. This is explained by continuing
favourable trends, such as the growing internationalization of TNCs/MNCs, which is expected to trigger a new wave of international investment projects when the effects of the present crisis begin to ease. The impact of the short-term fall in FDI flows is of particular concern for developed countries, as its negative effects on them are compounded by a continuing trend in favour of emerging markets in TNCs/MNCs’ location strategies.

Foreign Direct Investment perspectives on the issues that will shape investment in 2010-2011 are evident from leading developed country sources in the field as well as emerging nations like BRICKS (Brazil, Russia, India, China, Korea, and South Africa) and also developing countries like Malaysia, Thailand, and Sri Lanka. While the current market environment is demanding, it could still open up valuable opportunities for strategic growth through FDI. TNC/MNC CEOs can look for opportunities to take advantage of the current market conditions to grow their business or use the opportunity to transform their business model through a more sustainable approach to long-term value creation. In sum, current market conditions will continue to provide TNC/MNC CEOs with FDI opportunities. In pursuing them they should not overlook fundamentals and do their homework in assessing and pursuing long term investment opportunities. Emerging market opportunities are a case in point. For the developing countries including Sri Lanka, for which FDI is an important source of external financing, the major challenge is to improve their local business environment and absorptive capacity in order to enhance their attractiveness for TNCs/MNCs to avail themselves of investment opportunities. At the same time, however, for the handful of big emerging markets like China and India that have the financial and industrial capabilities to invest abroad, the crisis may also be a major opportunity to strengthen their influence in the global economy through an increased presence of their companies abroad for gaining competitive advantage, state-of-the-art technologies, and exchange of best practices with spill-over effects to advance reciprocally home country enterprise productivity, profitability and sustained growth.

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