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Foreign Direct Investment: Recent Trends and Implications for USAID

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Foreign Direct Investment: Recent Trends and Implications for USAID

This note accompanies USAID's revised and updated Resource Guide on *Foreign Direct Investment – Putting it to Work in Developing Countries*, prepared by Nathan Associates in December 2006. It highlights 9 major foreign direct investment (FDI) trends emerging in this new Resource Guide, plus possible implications of these trends for USAID Missions as they plan new strategies and programs.

1. FDI FLOWS TO THE DEVELOPING WORLD ARE EXPANDING AGAIN

Worldwide FDI flows peaked in 2000, and then – in an environment of global economic recession and uncertainty – declined through 2003 for both developed and developing countries. Since that low point, however, FDI inflows have again begun to grow. In the developing world the increase has been dramatic: in 2004 and 2005 FDI inflows rose by 67 percent from the 2002/2003 trough, and reached a new record level of \$285 billion (Figure 1). For 2006, early reports indicate that developing countries experienced a third consecutive year of FDI expansion, albeit a modest one. And for the rest of the decade, forecasts suggest that FDI flows to developing countries will continue to rise, although at a much more moderate pace than in the 2004/2005 return to FDI growth.

Possible implications for USAID Missions:

- Growing FDI activity is likely to be increasingly prominent in the economic landscape of many USAID partner countries. As the FDI Resource Guide makes clear, FDI can be an important force for **market-based economic policy reform, technology upgrade, small and medium enterprise (SME) growth and workforce development** in host economies. Accordingly, FDI-related initiatives may deserve strategic consideration by USAID Mission program planners and their counterparts in host country governments and the private sector.
- Guidelines for USAID foreign direct investment assistance are found in ADS 225. Summarized in the Resource Guide, this directive spells out **permitted activities**, as well as those prohibited or considered to be “gray area.”

2. REGIONAL FDI PATTERNS ARE SHIFTING IN THE DEVELOPING WORLD

FDI inflows increased in all regions of the developing world, reaching new highs in all regions but one (Latin America) in 2005 (Figure 2). East Asia and the Pacific continues to lead the developing world in attracting FDI with nearly one-third of total inflows, a small decrease from the 36 percent captured in 2003. China accounts for 80 percent of the regional total. Europe and Central Asia, where FDI has more than doubled since 2003, formerly ranked third but is now second in FDI inflows with over 28 percent of total. Its remarkable growth arises from the attraction of the European Union market and oil/gas-related FDI. Latin America and the Caribbean, which led all developing world regions in FDI from 1997 through 2001, is now third in FDI with about 24 percent of all inflows. While their regional totals are now higher than ever, the shares of FDI held by Sub-Saharan Africa (7 percent of total), Middle East and North Africa (6 percent) and South Asia (4 percent) still lag other regions.

Possible implications for USAID Missions:

- For USAID Missions, regional FDI flows are perhaps less important than country performance in attracting FDI. Some countries need no USAID help to compete for FDI, and others (e.g., in Eastern Europe) now profit from past USAID support in privatization and policy reform as they seek FDI. But many economies – large and small, across all regions of the developing world – can still benefit from USAID assistance to become more attractive and efficient FDI hosts.
- The kinds of assistance USAID should provide will depend on country circumstances. However, many USAID Missions now aim at domestic private sector development through investment climate assessments, institution-building, training, and policy dialogue and reform. In the context of FDI, such initiatives are particularly useful, for they have double impact: whatever improves the business environment for domestic investors also serve the needs of foreign ones.

3. SOUTH-SOUTH FDI IS SIGNIFICANT AND GROWING

Multinational enterprises based in developing countries have become increasingly important sources of FDI capital for other developing countries. This South-South FDI may have been about 37 percent of total FDI inflows to the developing world in 2003, up from 16 percent in 1995. Russia, China, Brazil, Mexico, Indonesia, and India are key FDI providers. Most South-South FDI is intra-regional – China is a major investor in Asia, for example, and South Africa is a major investor in Sub-Saharan Africa – but there are also rising inter-regional trends as well, notably Chinese and Indian investment in Sub-Saharan Africa. Much South-South FDI is directed to entering host-country or regional markets, but some is also natural resource-seeking. South-South FDI will likely to continue to grow in importance over the rest of the decade, multiplying the developing world's potential FDI sources.

Possible implications for USAID Missions:

- Products and services of South-based multinationals are often better adapted to local economies and technological conditions than those of developed countries, and thus especially likely to generate technology and other spillovers associated with FDI. Where USAID Missions support investment

promotion and competitiveness-building, emphasizing the growth of South-South FDI opportunities may well have a strategic payoff in terms of both quantity and quality of FDI.

- Analysis of South-South FDI transactions suggests that foreign investors based in developing countries are often more willing to focus on poorer and smaller markets than their counterparts in the North. Based on experience, they may be better equipped to operate in and bear the risk of these economies. For USAID Missions working in ***post-conflict situations or in the least-developed economies***, such South-based multinationals may be particularly appropriate partners in programs designed to stimulate investment and employment for economic recovery.

4. CHINA CONTINUES TO BE THE DEVELOPING WORLD'S FDI MAGNET – BUT THIS IS NOT THE FULL STORY

China attracts over \$70 billion in FDI annually, presently one-quarter of all yearly inflows to developing countries. Its huge internal markets and productive, relatively low-cost labor make it likely to be the leading developing country destination for FDI for years to come. However, other economies in East Asia benefit from China's rising FDI. Recent research shows a correlation between FDI increases in China and in East Asia generally. This is contrary to fears in ASEAN that with accession to the WTO, China's rise would reduce their own FDI inflows. Market size and policy variables (e.g., low corporate taxes and FDI openness) seem to be more critical for FDI attraction than the "China effect." Also, the complementarity between China's FDI and FDI in ASEAN underlines the fact that these economies operate in common production networks. China's recent off-shoring of certain production activities to low-cost Viet Nam or Cambodia simply reinforces this reality. Finally, China suggests what could lie ahead for another potential FDI magnet – India. China's FDI per capita stands at roughly \$56 (2005), while that of India is \$6. With 1 billion people, soaring economic growth and a steadily more enthusiastic embrace of economic liberalization, India has enormous potential to attract future FDI flows, and raise its own production networks in South Asia and Africa.

Possible implications for USAID Missions:

- For USAID Missions in ASEAN, South Asia and Sub-Saharan Africa, ***broad assistance in trade and investment capacity-building*** may help these economies enter into global production networks through expanded trade and investment relations with Chinese and Indian firms.

5. STRONG COMMODITY PRICES ARE BOOSTING FDI FOR EXTRACTIVE INDUSTRIES

Global economic recovery and continuing vigorous growth of major emerging market economies such as China and India have created high worldwide demand for natural resources. This has led to sharp rises in the price of oil (85 percent in 2004 and 2005) and other commodities (33 percent in these two years). Booming demand for hydrocarbons, minerals and other commodities has in turn stimulated major new flows of FDI into extractive industries in developing countries. Natural resource-seeking FDI has been very important in parts of Sub-Saharan Africa, Central Asia, the Middle East and North Africa, and Latin America. Even if world economic growth moderates some in the rest of the decade, relatively high commodity prices and long lead times for resource-seeking FDI projects mean continuing large FDI inflows for extractive industries in developing countries.

Possible implications for USAID Missions:

- Increased FDI inflows to developing world extractive industries have renewed traditional concerns regarding natural resource-seeking FDI: the costs and constraints of enclave industries, environmental damage, non-transparent and potentially corrupt investment transactions, and currency appreciation resulting in loss of manufacturing competitiveness. For USAID Missions in natural resource-rich countries, these issues may offer openings for assistance in areas of USAID comparative advantage: **linkage-building for SMEs, modern environmental practices, transparency and economic governance, and sound macroeconomic policy management.**
- Additionally, a boom in natural-resource seeking FDI only intensifies the disadvantages of natural resource-poor developing countries in competing for foreign capital. This simply reinforces the need in these countries for **basic investment climate improvement**, a priority for which USAID Missions worldwide have acquired considerable experience and expertise.

6. PRIVATE INVESTMENT IN PUBLIC INFRASTRUCTURE IS SURGING

Fueled by FDI, private participation in infrastructure (PPI) was widespread in the developing world in the 1990's, particularly in Latin America and East Asia. But after the Asian Financial Crisis, severe economic slumps in Argentina, Russia and Brazil, and global economic recession, PPI declined precipitously until 2003. Since then, however, PPI has rapidly recovered, and reached a total of \$96 billion in 2005, an increase of over 80 percent. All regions of the developing world have benefited, with Europe and Central Asia and South Asia setting new records. Telecoms and transport – especially airports and seaports – have been major recipient sectors for PPI. Given the massive need for infrastructure improvement in developing economies, and the expertise and capital available among multinational providers of infrastructure systems and services, this new cycle of PPI will surely gain momentum over the next 10 to 15 years, and will represent an important driver of FDI.

Possible implications for USAID Missions:

- Under economic stress, design weaknesses in many PPI projects emerged: impractical pricing provisions, unsuitable regulatory structures, inadequate competition, unsustainable government guarantees. These are mistakes that must be rectified in the current PPI cycle. Many USAID Missions will be well placed to **build capacity in counterpart agencies to design, negotiate and monitor privatized infrastructure arrangements** that are economically and socially sound.
- In the 1990's, several USAID Missions were involved in supporting host government programs for Build Operate Transfer (BOT) and Build Own Operate (BOO) projects. That experience, together with USAID's **expertise and training resources in regulatory economics, competitive markets, commercial law reform and economic governance**, will be in high demand to help host economies maximize the benefits of FDI in infrastructure development.

7. EFFICIENCY-SEEKING FDI IS AN INCREASING SHARE OF ALL FDI IN DEVELOPING COUNTRIES

Seeking markets and seeking efficiency are the two principal business motivations for FDI. Market-seeking FDI – investing in foreign operations to enter new markets in FDI host countries – probably still accounts for about one-half of all FDI inward stock in the developing world. But efficiency-seeking FDI – investing in foreign operations to create the most cost-effective and competitive global production networks – is rapidly gaining ground, and may now be about 40 percent of FDI stock. In the past 15 years most efficiency-seeking FDI has been in manufacturing, and has been mirrored in the rise of network trade in parts and components. More recently such FDI has also been increasingly directed to services (e.g., business processing operations, IT services, call centers, and R&D). Continuing technology improvements, global cost pressures and trade liberalization guarantee efficiency-seeking FDI's future growth – but deregulation in major developing world markets (e.g., finance or logistics in China, retail in India) ensure increases in market-seeking FDI as well.

Possible implications for USAID Missions:

- Efficiency-seeking FDI is closely tied to trade expansion and liberalization. For countries striving to attract efficiency-seeking FDI, ***trade-capacity building and trade policy liberalization*** – areas of expertise for many USAID Missions – are thus essential. Support for workforce development, technology improvement and SME integration into major supply chains may also be required.
- In countries with potential for market-seeking FDI, USAID Missions may provide priority assistance in ***deregulation and competition policy*** to liberalize trade and investment and to improve the functioning of domestic markets, industries and firms.

8. THE END OF GLOBAL TEXTILE/APPAREL QUOTAS HAS HAD MIXED IMPACTS ON FDI

Allocation of Multifibre Arrangement (MFA) quotas encouraged textile/apparel sector FDI in the developing world. Since the end of MFA (January 2005), much textile/apparel production has shifted to China, and some disinvestment in the industry has occurred. But thus far results are mixed. Disinvestment continues to threaten many countries (e.g., Kenya, Mauritius, Lesotho), but some (e.g., Bulgaria) have been able to move from simple assembly to higher value-added apparel to retain FDI in the industry. And it appears that textile/apparel buyers want some diversification of supply, which helps countries with very low wages (e.g., Viet Nam, India) or special location and trade advantages (e.g., the Dominican Republic under CAFTA) to continue to attract apparel FDI.

Possible implications for USAID Missions:

- For USAID Missions in countries with large textile and apparel sectors, ***assistance in post-MFA industry adjustment*** is likely to continue to be urgently needed. Such assistance may focus on apparel industry competitiveness-building through product design and marketing, worker training/retraining, technology improvement and strengthening upstream SME supplier linkages.
- Where such countries also have preferential trade arrangements with the US (e.g., AGOA or Free Trade Agreements), technical assistance to ***industry associations and small and medium-sized firms*** to take advantage of the benefits of these agreements could be a priority.

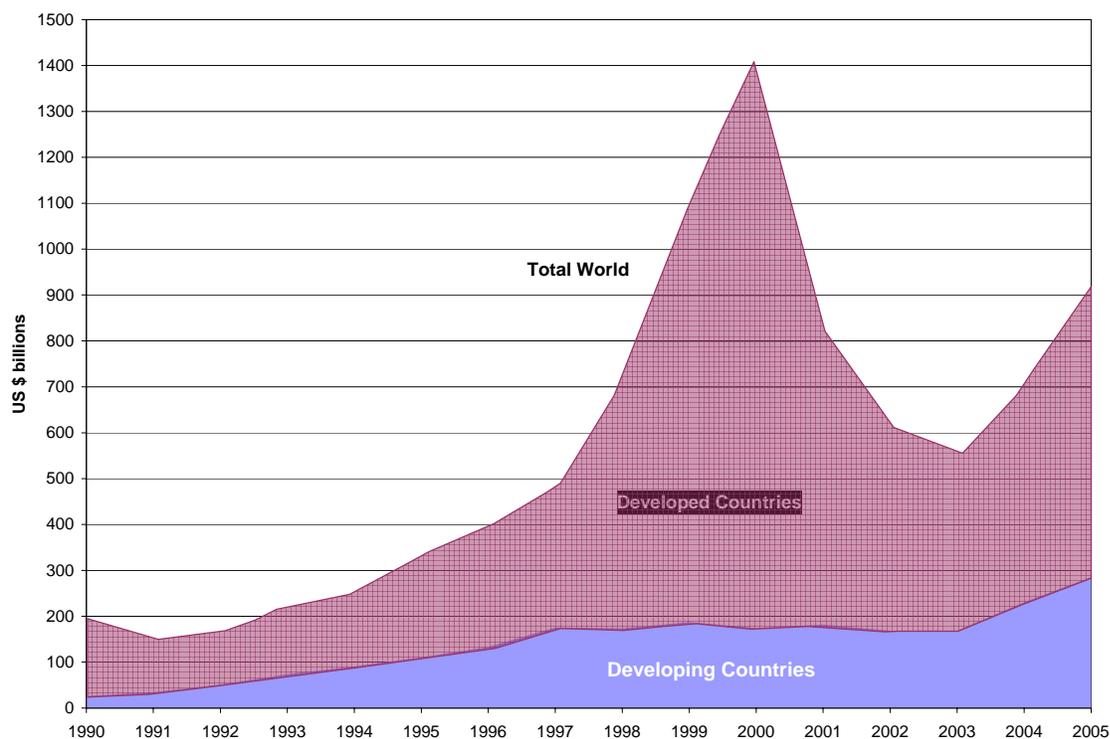
9. OECD'S POLICY FRAMEWORK FOR INVESTMENT (PFI) IS AN IMPORTANT NEW ANALYTICAL TOOL

Several useful tools can help reformers and policymakers assess and respond to needs for investment climate improvement. These include the World Bank's annual Doing Business surveys, as well as the Global Competitiveness Index of the World Economic Forum. In 2006 the OECD added to the toolkit with its Policy Framework for Investment (PFI), which aims at mobilizing private investment and maximizing its development benefits. The PFI is a series of 10 mutually reinforcing checklists in the 10 policy domains determined by the OECD to have the strongest impact on the investment environment: investment policy, investment promotion and facilitation, trade policy, competition policy, tax policy, corporate governance, responsible business conduct, human resource development, infrastructure and financial sector development, and public governance.

Possible implications for USAID Missions:

- For USAID Missions engaged in providing assistance in microeconomic reform, the PFI checklists may be valuable in ***identifying priorities, framing policy proposals and providing guidance in reform monitoring and evaluation***. These checklists are flexible and are designed to create attractive investment environments for all investors, domestic and foreign, large and small.

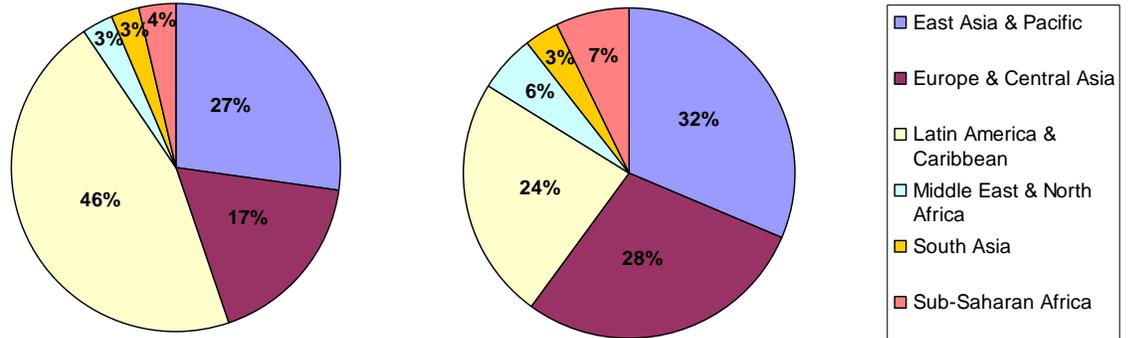
Figure 1: FDI Inflows, Developed and Developing Countries, 1990-2005



Note: Includes only economies classified as low or middle income by the World Bank (those with a 2005 per capita GNI of \$10,725 or less). Income groups are defined according to per capita gross national income in 2005: low income, \$875 or less; lower middle income, \$876–3,465; upper middle income, \$3,466–10,725; high income, \$10,726 or more.

SOURCES: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007* for country classifications.

Figure 2: FDI Inflows to the Developing World, by Region, 2000 and 2005



Note: Includes only economies classified as low or middle income by the World Bank (those with a 2005 per capita GNI of \$10,725 or less). Income groups are defined according to per capita gross national income in 2005: low income, \$875 or less; lower middle income, \$876–3,465; upper middle income, \$3,466–10,725; high income, \$10,726 or more. Regional groupings from World Bank, *World Development Report 2007*.

SOURCES: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007*.