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Technical Briefing on the New, Updated USAID Resource Guide on Foreign Direct Investment

In January 2007, USAID revised and updated its Resource Guide on *Foreign Direct Investment – Putting it to Work in Developing Countries*. First published in 2005, the guide highlights major foreign direct investment (FDI) emerging trends and their implications for USAID Missions. The updated version of the guide was produced by Nathan Associates for the EG Office.

Some of the new trends for developing countries:

- FDI flows to the developing world are expanding again: Inflows rose by 67% between 2002 and 2005.
- Efficiency-seeking FDI – to capture cost-effective and competitive global production networks – now represents an estimated 41% of total FDI to developing countries. (Most of the other 59% is described as "market-seeking" since its primary purpose is to gain market share in the local market rather than to help minimize unit costs of a global production network in which off-shoring to low cost high-efficiency producers is a key part of the strategy; a small portion is "natural resource seeking. See the Annex).
- South-South FDI is significant and growing. In 2003, South-South FDI grew to 37% of total FDI to developing countries, up from 16% in 1995.
- China continues to be an FDI magnet – but this is not the whole story - East Asian markets are benefiting from China's own off-shoring of some of its production activities.

The new FDI trends have important implications for USAID's work in the field:

- The growing supply of FDI and the growing share of it that is efficiency-seeking, creates an opportunity and a necessity to improve USAID's partner countries' ability to attract their share and reap its full benefits. Funding for business climate reform and trade capacity building will be particularly important.
- Sub-Saharan Africa, South Asia, and Middle East need help to catch the up with the rest of the world.
- Many of the countries with the potential to attract significant new FDI need special support to develop effective competition policies and market-oriented regulatory regimes.
- USAID should position itself to help more countries develop systems and capacities to benefit from increased private FDI for infrastructure.
- USAID missions working in post-conflict situations or in least-developed economies should seek to attract or partner with South-based multinationals, as these generally are willing to bear a higher level of risk than North-based firms, in programs to stimulate investment and employment for immediate economic recovery.

For more details, please refer to the Annex of this briefer. We will distribute hard copies of the report when it is completed. We anticipate printing in June or July and will post an electronic copy of the report on the EG pages of the USAID intranet about that time.

Technical Briefings is published by USAID/EGAT Office of Economic Growth (EG) in Washington, D.C. This publication aims to share technical and analytical information with USAID field missions, especially with economic, private sector, and agricultural development officers. Any views, or interpretations expressed in *Technical Briefings* are those of the author(s) alone and do not represent any official view of USAID or the U.S. government. If you have feedback, suggestion or ideas about *Technical Briefings*, please contact Jim Elliott (jelliott@usaid.gov). Suggestions for subjects are welcome. Draft technical briefs of no more than two pages in length from readers will be considered. This Technical Briefing was authored by Patterson Brown of EGAT/EG/TIF. Valuable suggestions for improvements came from Bob Aten.

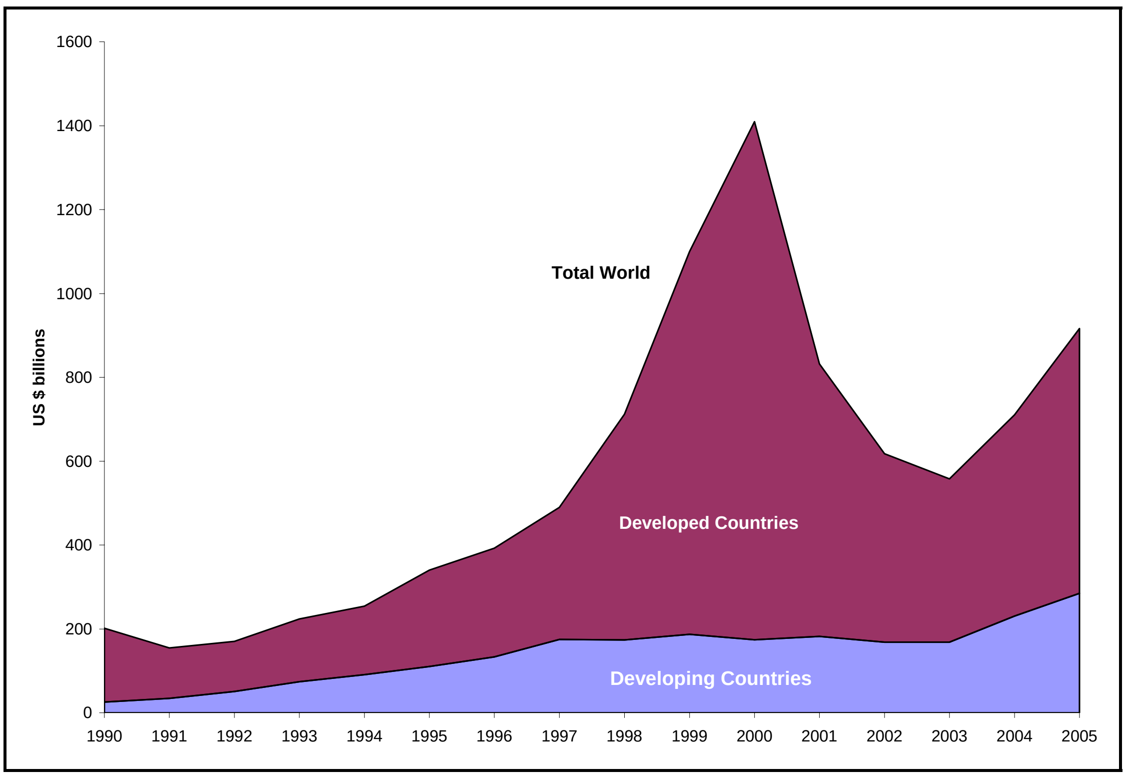
FOREIGN DIRECT INVESTMENT: TRENDS AND IMPLICATIONS FOR USAID

USAID revised and updated its *Resource Guide on Foreign Direct Investment (FDI) – Putting it to Work in Developing Countries*. Prominent new findings and implications for Missions include:

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 in 2003, FDI inflows have increased. In the developing world the increase has been dramatic: in 2004 and 2005 FDI inflows rose by 67% from the 2002/2003 trough of about $167 billion, and reached a new record level of $285 billion. For 2006, early reports indicate that developing countries experienced a third consecutive year of FDI expansion, albeit a more modest one. Forecasts suggest FDI flows to developing countries will at least stay at their current high levels for several years, or continue to grow though at smaller rates than in 2004 and 2005.

FDI Inflows, Developed and Developing Countries, 1990-2005



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

IMPLICATIONS FOR USAID:

- Growing FDI activity is likely to be increasingly prominent in the economic landscape of many USAID partner countries. 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.

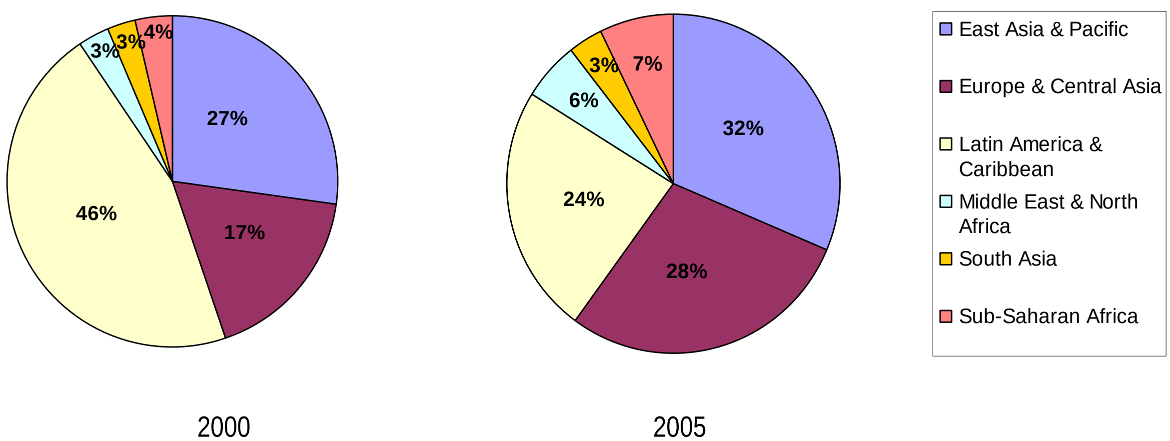
Possible Dutch disease side effects of large FDI inflows may need mitigating.

The update mentions, in an end note, that countries receiving large amounts of FDI of the “natural resource-seeking” variety may experience adverse, “Dutch disease” effects (e.g. inflation, appreciating of the real exchange rate handicapping exports and production of traded goods for the domestic market) negating to some extent the benefits of FDI.[1] It might be added that for political economy reasons, the Dutch disease-like effects of large amounts of most FDI are probably less severe than those of similarly large amounts of export revenues from export of state-owned natural resource based products.

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 continue to lead the developing world in attracting FDI with nearly one-third of total inflows, a small decrease from the 36% garnered in 2003. China accounts for 80% of the regional total. While now higher than ever, the shares of FDI attracted by Sub-Saharan Africa (7% of total), Middle East and North Africa (6%) and South Asia (3%) still lag other regions.

FDI Net Inflows to the Developing World, by Region, 2000 and 2005



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

IMPLICATIONS FOR USAID:
- The kinds of assistance USAID should provide will depend on country circumstances. However, many USAID Missions already target 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, because they have double impact: whatever improves the business environment for domestic investors also serve the needs of foreign ones.

China continues to be developing world's FDI magnet – but this is not the whole story.

China attracts over $70 billion in FDI annually, at present one-quarter of all yearly inflows to developing countries. Its huge internal markets and productive, relatively low-cost labor make it likely to continue as the leading FDI destination. However, recent research shows that East Asia benefits from China's FDI. China's recent off-shoring of certain production activities to low-cost Viet Nam and Cambodia reinforces this. 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 simply low cost labor or the "China effect." 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.

IMPLICATIONS FOR USAID:
- 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.

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% of total FDI inflows to the developing world in 2003, up from 16% in 1995. Russia, China, Brazil, Mexico, Indonesia, and India are key FDI providers. Most South-South FDI is intra-regional –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.

IMPLICATIONS FOR USAID:
- Products and services of South-based multinationals are often better adapted to local economies and technological conditions than those of developed countries, 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 can have strategic payoffs in both quantity and quality of FDI.

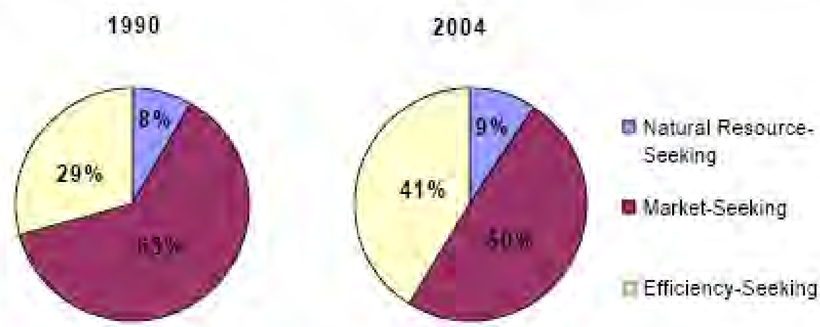
- Analysis of South-South FDI transactions suggests that foreign investors based in developing countries are often more willing to focus on poorer and smaller markets than their counterparts in the North. Based on experience, they may be better able to operate in and bear the risk of these economies.

- For USAID Missions working in post-conflict situations or in the least-developed economies, such South-based multinationals may be particularlyappropriate partners in programs designed to stimulate investment and employment for economic recovery.

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, or total accumulated amount of inward FDI, 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 now estimated at 41% of total accumulated FDI. 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.

Figure 2-1. Estimated Distribution of Developing Countries' Inward FDI Stock by Business Purpose, 1990 and 2004



IMPLICATIONS FOR USAID:

- Natural-resource seeking FDI only intensifies the disadvantages of natural resource poor developing countries in competing for foreign capital. This simply reinforces the need for basic investment climate improvement.

- 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 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.

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, such participation declined precipitously until 2003. Since then, however, PPI has rapidly recovered to reach a total of $96 billion in 2005, an increase of over 80%. 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 from multinational providers of infrastructure systems and services, this cycle of new PPI will surely gain momentum over the next 10 to 15 years.

IMPLICATIONS FOR USAID:

- 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. USAID Missions should focus on building capacity in counterpart agencies to design, negotiate and monitor privatized infrastructure arrangements.

- 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.

OECD's Policy Framework for Investment 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 toolkits available with its Policy Framework for Investment (PFI). 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, including: investment policy, investment promotion and facilitation, trade policy, competition policy, tax policy, corporate governance, financial sector development, and public governance. The PFI checklists are valuable in identifying priorities, framing policy proposals and providing guidance for monitoring and evaluation. The checklists are designed to create attractive investment environments for all investors, domestic and foreign, large and small.

IMPLICATIONS FOR USAID:

- 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.

[1] Dutch disease is a common name for the adverse effects arising from large inflows of foreign exchange into a country's economy. It is a standard phenomenon in developing country economies but is not exclusive

to them. Dutch disease in the narrow, historical sense refers to the adverse effects of large inflows of foreign currency from exports of natural-resource-based products such as crude oil and gas. Its name derives from the experience of the Netherlands in the 1960s with the effects with massive currency inflows from export of gas from its North Sea fields. More generally, one speaks of the Dutch disease-like effects of large foreign currency inflows from such sources as natural-resource-based exports, remittances, foreign assistance and FDI. These effects include: appreciation of the real exchange rate with adverse effects on production for export, excessive expansion of the money supply and high inflation, and a shift of domestic resources away from exports and towards production of goods not traded internationally. As the report puts it, in a footnote "a sharp expansion in commodity exports induced by natural-resource-seeking FDI could lead to a sustained increase in export revenues from extractive industries and significantly appreciate the host country currency. This could lead to "Dutch disease" wherein currency appreciation renders [most other] exports uncompetitive". One could add that the Dutch-disease-like effects of large amounts of most kinds of FDI are probably less severe than those of similarly large amounts of export revenues from export of natural-resource-based products. But there may be some side effects of this kind and as they may pose some problems for macro economic management, policy makers and USAID staff should be aware of them