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# **FDI in Developing Countries and Economies in Transition: Opportunities, Dangers, and New Challenges**

## Introduction

The role of FDI in the developing countries and economies in transition has grown dramatically over the course of the 1990s, from \$24 billion per year in 1990 to approximately \$120 billion per year by the beginning of 1998. FDI flows remained relatively robust right through the Mexican peso crisis of 1994-95. If history is a guide, international companies are not likely to pause for long with their investment plans as the Asian economies resume their growth.

Private capital flows now total more than four-fifths of all capital inflows to the less-developed countries and the economies in transition. Among these private capital flows, FDI is by far the largest and most stable source of capital, climbing in recent years to near 50 percent (see tables I.1 and I.2).

The distribution of FDI to the developing countries and economies in transition has been quite uneven. The top 10 countries received \$89 billion, or 72 percent of the FDI flows, in 1997. Since 1992, China has attracted the largest proportion, reaching a high of \$42 billion, or 38 percent of the total, in 1996 (although some substantial component of this represents what is called "round tripping" by indigenous capital holders).

But the potential to attract foreign investors is not a static phenomenon. Over the course of the 1990s, individual countries have improved their prospects considerably, with strengthened performances on the part of Hungary and Poland in Eastern Europe; Argentina and Venezuela in

**Table I.1 Aggregate net private capital flows to developing countries, 1990-97** (billions of dollars unless otherwise noted)

Type of flow	1990	1991	1992	1993	1994	1995	1996	1997
Total private flows	41.9	53.6	90.1	154.6	160.6	189.1	246.9	256.0
Debt flows	15.0	13.5	33.8	44.0	41.1	55.1	82.2	103.2
Commercial bank loans	3.8	3.4	13.1	2.8	8.9	29.3	34.2	41.1
Bonds	0.1	7.4	8.3	31.8	27.5	23.8	45.7	53.8
Other	11.1	2.7	12.4	9.4	4.7	2.0	2.3	8.3
FDI	23.7	32.9	45.3	65.6	86.9	101.5	119.0	120.4
Portfolio equity flows	3.2	7.2	11.0	45.0	32.6	32.5	45.8	32.5
Aggregate net resource flows	100.6	122.5	146.0	212.0	207.0	237.2	284.6	300.3
Private flows share (percentage)	44.1	46.4	62.1	74.1	77.9	77.7	85.7	85.2

Source: *Global Development Finance*, World Bank Debtor Reporting System, World Bank (1998).

**Table I.2 FDI flows to the top 10 recipient developing countries** (billions of dollars unless otherwise noted)

	1991		1994		1997
Mexico	4.7	China	33.8	China	37.0
China	4.3	Mexico	11.0	Brazil	15.8
Malaysia	1.0	Malaysia	4.3	Mexico	8.1
Argentina	2.4	Peru	3.1	Indonesia	5.8
Thailand	2.0	Brazil	3.1	Poland	4.5
Venezuela	1.9	Argentina	3.1	Malaysia	4.1
Indonesia	1.5	Indonesia	2.1	Argentina	3.8
Hungary	1.5	Nigeria	1.9	Chile	3.5
Brazil	1.1	Poland	1.9	India	3.1
Turkey	0.8	Chile	1.8	Venezuela	2.9
Share in FDI of top 10 to all developing countries (percentage)	74.2		76.1		72.3

Source: *Global Development Finance*, World Bank Debtor Reporting System, World Bank (1998).

Latin America; Kazakhstan, Uzbekistan, and Azerbaijan in Central Asia; India in South Asia; and Vietnam and the Philippines in Southeast Asia.

Underlying this growing role for FDI in the developing countries and economies in transition has been a transformation in perspective, from critical wariness toward multinational corporations to sometimes uncritical enthusiasm about involving foreign firms in the development process.

Is uncritical enthusiasm warranted? How and where might it have to be tempered? What are the benefits and opportunities that foreign firms have to offer? What risks and dangers might they pose? Beyond improving the micro and macroeconomic fundamentals in their own countries and building appropriate investment-friendly institutional infrastructure, do host countries in the developing countries and the economies in transition need an active (or proactive) policy toward FDI? Where should host authorities focus their attention as they design policies to maximize the benefits, and avoid the dangers, of incorporating FDI into their development strategies?

Chapter 1 provides background on theory and evidence about the impact of FDI on development, as a framework for the detailed studies of individual policies and extensive review of evidence in particular industries that follow.

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# **The Impact of FDI on Host-Country Development: The Heritage of Theory and Evidence**

What impact does FDI have on the standards of living and prospects for economic growth of developing countries and economies in transition that receive it?

Two alternative conceptualizations of the impact of FDI guide the understanding of its potential contribution to the economic development of the host country. The first emphasizes the net addition of inputs that foreign investors may bring to a domestic setting of vigorous (if not perfect) competition. The second emphasizes the potentially distortionary impact that foreign investors from imperfectly competitive international industries may have on domestic economies that are themselves riddled with market imperfections.

Both these conceptualizations, or models, are plausible. But they predict widely different outcomes—the first greatly positive, the second much more problematic and (under some circumstances) decidedly negative.

Which structure more closely fits the setting for FDI in the less-developed countries? And how might the potential for negative outcomes be diminished?

## **The Benign Model of FDI and Development**

Perhaps the most prevalent version of the beneficial conceptualization begins with a stylized description of how FDI may help the host country to break out of the vicious cycle of underdevelopment. Here, the potential host is mired in a poverty-laden equilibrium: low levels of productivity

lead to low wages, which lead to low levels of saving, which lead to low levels of investment, which perpetuate low levels of productivity.

FDI can break this cycle by complementing local savings and by supplying more effective management, marketing, and technology to improve productivity (Gillis et al. 1996; Cardoso and Dornbusch 1989). The gain in national income depends on the size of the capital inflow and the elasticity of the demand for capital. Furthermore, technological and managerial inputs, and transfers and spillovers to local firms may cause the national production function to shift outward.

Thus, under reasonably competitive conditions—which the foreign presence may enhance—FDI should raise efficiency, expand output, and lead to higher economic growth in the host country. Indeed, the interaction between economic and social development should be positive as well: the additional supply of capital should lower the relative return to capital while the additional demand for labor should bid up the wages of workers, thereby equalizing the distribution of income and improving (quite probably) health and education throughout the society.<sup>1</sup>

The emphasis on the new resources that foreign investors bring to relieve the bottlenecks that constrain development is a common theme among international business groups and multilateral agencies that urge greater acceptance of international corporations within the developing countries and economies in transition. It is the prevailing assumption in macroeconomic growth models that gaps in savings and in foreign exchange set the limits to long-term growth.

## The Malign Model of FDI and Development

There is a long history of criticism of multinational corporations. Much of it centers on the possibility that foreign investors will thwart the passage of laws that constrain socially undesirable practices—such as pollution regulations or health, safety, and minimum wage requirements—or ignore laws already enacted. But there is also a strand of criticism that focuses directly on the central relationship between FDI and the prospects for economic growth.

This alternative conceptualization to the benign model (above) emphasizes the potential malign interaction between FDI provided by foreign companies in imperfectly competitive international industries and host economies with imperfectly competitive domestic markets. Here, foreign companies operate in industries where there are substantial barriers to entry, enjoying and perhaps increasing (rather than decreasing)

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1. For the debate about the assumptions required to generate such a favorable outcome, see Cardoso and Dornbusch (1989).

market concentration (Cardoso and Dornbusch 1989; Grieco 1986). Instead of filling the gap between savings and investment, they may lower domestic savings and investment by extracting rents and siphoning off capital through preferred access to local capital markets and local supplies of foreign exchange. Instead of closing the gap between investment and foreign exchange, they might drive domestic producers out of business and substitute imported inputs. The multinational company may reinvest in the same or related industries in the host country and extend its market power. The repatriation of profits might drain capital from the host country.

Far from generating a favorable impact on income distribution and social development, their operations may support a small oligarchy of indigenous partners and suppliers. Their use of "inappropriate" capital intensive technology may produce a small labor elite while consigning many workers to the ranks of the unemployed (or underemployed) if local labor market rigidities fail to deploy them to more productive occupations. Their tight control over technology, higher management functions, and export channels may prevent the beneficial spillovers and externalities hoped for in the more optimistic scenarios.

Which of these conceptualizations, the first overwhelmingly favorable and the second overwhelmingly unfavorable, better describes FDI in the less-developed countries and economies in transition?

## **Theory and Evidence about Market Structure and FDI**

For either of them to be used as the model of the interaction between FDI and host country development requires a multitude of assumptions, most having to do with how competitive the industry and economy are where the FDI takes place.

In the theory of FDI, the prevalent assumption since the earliest work of Hymer (1976), Vernon (1966), and Kindleberger (1969) has been that barriers to entry and imperfect competition are the sine qua non for the FDI process to be possible. This tradition of analysis postulates that for firms to operate outside their own home economy, they must possess some sort of specific advantages over rival firms in other national markets. These specific advantages may include control over technology, proprietary rights to brand names, economies of scale realized by operating across more than one national market, and other intangible assets derived from organizational and managerial expertise internal to the firm. Such specific advantages are necessary to offset the extra costs associated with communication and coordination among far-flung subsidiaries; they are also necessary to offset the counteradvantages that local firms might have in dealing with local labor, local public relations, local tastes, and local culture.

Absent the specific advantages, one would expect entrepreneurs in each national market to have a superior position from which to recognize nearby economic opportunities and take advantage of them. But possession of one or more of the specific advantages constitutes a barrier to entry into the industry for host-country firms that an international investor can exploit in search of economic rents.

Why should the international company try to exploit the barrier to entry, however, via the cumbersome apparatus of setting up a subsidiary rather than merely licensing a local firm to work on the parent firm's behalf?

Licensing is, in fact, one common method of expanding operations abroad. But it is difficult to protect the ability to extract oligopoly rent via licensing in a world of imperfect contracts and principal/agent problems. In addition, the local firm has a self-interest in learning how to duplicate organizational and managerial skills and to maneuver around proprietary restraints over technology and marketing. These factors lead the parent firm to internalize the rent collecting ability via direct ownership over international operations (for difficulties similar to those of licensing, see the analysis of joint ventures in chapter 7) (Caves 1996; Dunning 1988, 1993b; Buckley and Casson 1976).

FDI therefore becomes a parent-firm strategy to extend or defend the ability to generate oligopoly rents derived from barriers to entry first established in the home-country market in response to conditions there. This model and other variants of it have helped to account for what has otherwise been a puzzle, namely, why multinational manufacturing corporations expanded their operations earliest and most vigorously in countries with similar demand structures (e.g., from the United States into Europe, and vice versa), even though both were regions of relative capital abundance.

FDI (especially manufacturing investment), then, takes two tracks: first, to cater to local markets that have similar demand structures as the developed countries at least among a small elite or middle class (this market is often protected by high trade barriers), and second, to exploit locales that can serve as export platforms to reinforce the competitive position of the parent companies regionally and globally.

As for natural resource industries, FDI is largely driven by geology. But the understanding of FDI in these sectors also derives from the dynamics of imperfect competition (Moran 1974; McKern 1993). At the production stage, there are often barriers to entry, deriving from scale, capital intensity, technology of exploration and exploitation, and intangible assets associated with managing large complex engineering operations on time and on budget. At the same time, factors of scale, capital intensity, and processing technology subject players with high fixed costs at positions upstream and downstream from each other with sudden shifts in monopoly or monopsony power. With profitability extremely sensitive to variations in throughput, the parent firms resort to mecha-

nisms of formal or informal vertical integration, ranging from sole ownership, to joint ownership of various stages, to long-term contracts for large volumes at slowly moving arm's-length price averages. Such mechanisms of formal or informal vertical integration help to insulate them from abrupt price gouging and large fluctuations in volume.

In both natural resources and manufacturing, oligopoly dynamics—including great circumspection about what international rivals are doing, caution about unilateral initiatives, and rapid matching moves to counter the initiatives of others—may figure prominently. Such oligopoly dynamics might show characteristics of deterrence, preemption, retaliation, and hostage exchange (Knickerbocker 1973; Graham 1978, 1996b).

What does the evidence suggest about market structure and FDI? Looking first at the industries in which FDI originates, measures show that imperfect competition is pervasive. There is a strong correlation between high concentration ratios and outward investment for the United States, the United Kingdom, France, Germany, Sweden, and Japan. Outward investment is found in industries in which there are large economies of scale and high advertising and technology intensity (Caves 1996; Frischtak and Newfarmer 1994).

Turning to market structure in the developing-country economies that receive incoming FDI, there is again pervasive evidence of a correlation between market imperfections and FDI (Dunning 1993b; Lall 1978; Blomstrom 1986; Willmore 1976; Connor 1977; Rodrik 1988). In eight regressions using Mexican data, Blomstrom and Persson (1983) found that the foreign firms' ownership of productive capacity in the local market was highly correlated with a Herfindahl index of market concentration. In a similar study on Brazil, Newfarmer and Marsh (1992) also found a high correlation between foreign ownership and industry concentration. Earlier studies of Mexico and Brazil showed that 84 percent of foreign subsidiaries in Mexico and 83 percent of foreign subsidiaries in Brazil were in industries where four-firm concentration ratios exceeded 50 percent, and 21 percent of the foreign subsidiaries in Mexico and 58 percent of the subsidiaries in Brazil were in industries where the four-firm concentration ratio exceeded 90 percent. There are similar correlations between market concentration and foreign-firm presence in Peru, Chile, Colombia, Central America, and Malaysia.

In short, theory and evidence indicate that FDI takes place in a setting with many of the characteristics of the malign model. Such a setting carries threats and dangers, as well as opportunities, for host-country development in the developing countries and economies in transition. At the same time, those characteristics of imperfect competition that are so worrisome indicate that FDI may feature rents (including high profits and high wages), access to privately controlled activities (including technology, marketing, and best management practices), and potential spillovers and externalities that are of high value to host economies.

This is the precarious position in which host authorities find themselves as they try to design policies toward foreign investors with the aim of generating rapid growth and higher standards of living for their populations. What are the most likely results?

There have been three principal attempts to provide an aggregate net assessment of the contribution of FDI to national incomes in the developing world. They offer a useful background for examining host country policy options in the subsequent chapters.

### **Three Earlier Net Assessments of the Impact of FDI on Development**

These three studies cover 133 projects (principally manufacturing, agribusiness, and natural resource processing, rather than mineral or petroleum extraction) in more than 30 countries, plus some 50 proposed projects in one country, over more than 15 years. The studies were undertaken under widely different auspices and with widely different starting perspectives, yet they came to remarkably similar conclusions.

In a study for the United Nations Conference on Trade and Development (UNCTAD), Lall and Streeten (1977) examined 88 foreign-owned and locally owned projects operating in 6 countries, using cost-benefit analysis to calculate national-income effects. For two-thirds of the 88, foreign investment had a positive effect on national economic welfare; for the other one-third, it was negative. The key factor skewing the outcome in one direction or the other was the competitiveness of sales.

In a study for the OECD, Reuber (1973) led a team that analyzed a sample that comprised 45 foreign-owned projects in some 30 host countries. He compared the production costs of the subsidiaries to the production costs of the parents. While not set up explicitly like the study by Lall and Streeten (1977), his methodology approximated a social cost-benefit analysis that assumed that all inputs were valued at local market prices and all outputs were valued at world market prices. He found that over one-quarter of the subsidiaries had production costs that were equal to or lower than the production costs of the parents but that the remaining subsidiaries—almost three-quarters of the entire sample—had higher production costs. Again, the factor that determined whether the social benefit to the host country was positive or negative was the competitiveness of sales.

In a study for the Overseas Development Council, Encarnation and Wells (1986) calculated the contribution that 50 proposed FDI projects made to national income, at world market prices, minus the costs to the national economy, again at world market prices (frequently using shadow prices for labor, energy, foreign exchange, and domestic capital to reflect

the opportunity cost of the resources to the domestic market). They found that a majority of the 50 projects (from 55 percent to 75 percent, depending upon the assumptions) would increase national income, while the remaining sizable minority (25 percent to 45 percent) would actually reduce the country's national income, even though they were profitable to the foreign investors that undertook them.

As in the previous two studies, the difference between positive and negative impact was not a close call: the results tended to be overwhelmingly positive or overwhelmingly negative. Once again, the difference came from the competitiveness of the markets in which the foreign investments took place, including the competitiveness of input and output markets, which were often influenced by host-country regulatory policy.

These aggregate studies provide three common conclusions. First, FDI may well have a clear, positive impact on development. In fact, as the evidence introduced in subsequent chapters demonstrates, these three assessments far underestimate the benefits (static and dynamic) that well structured FDI projects potentially can provide to host country development.

Second is an equally significant obverse observation, namely, that FDI can also have a demonstrably negative impact on the host's prospects for development (sufficiently negative that the host society would be better off not receiving the FDI at all). In fact, as evidence introduced in the subsequent chapters demonstrates, these three assessments far underestimate the direct damages to and lost opportunities for host-country development caused by ill-structured projects.

Third, a primary factor accounting for whether the impact is strongly positive or strongly negative is the extent of competition in the markets in which the FDI is embedded. In fact, as the evidence introduced in the subsequent chapters demonstrates, host actions in stimulating or retarding competition wherever foreign investors are located will constitute the most important determinant of whether the host benefits or suffers from the presence of foreign firms.

With a perspective toward FDI that highlights the possibility of substantial dangers as well as substantial opportunities, the next chapters turn to the design of specific host-country policies toward foreign investors.