

**Foreign Direct Investment and Development:
A Literature Review and Bibliography**

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1. Introduction

Foreign direct investment (FDI) now represents the most important form of foreign capital inflows for many developing countries (1998). From the mid-1980s to mid-1990s, private capital flows to less developed countries nearly doubled (Marr 1997). FDI is the largest and fastest growing source of external finance for developing countries as a group. In 1996, 39 percent of total external finance was from FDI while only 31, 16 and 14 percent came from private debt flows, portfolio equity investments, and official development finance, respectively (World Bank 1997). Never before has there been so much emphasis placed on FDI's potential role in accelerating economic growth and in contributing to development. The rapid export-led growth of the NIEs in Asia in the 1990s is often used as an example of FDI's positive impact. However, despite the benefits attained from FDI in some countries, theoretical and empirical research on the impacts of FDI across countries is not as conclusive as one might be led to believe. This report summarizes the main themes in recent literature related to FDI with an emphasis on its potential role in the development process.

2. FDI trends

Total inflows of FDI increased for the seventh consecutive year in 1997 reaching a record level of \$400 billion (UNCTAD 1998). FDI has become a powerful globalising force in the world economy, with growth rates surpassing those of trade in recent years. While FDI increased nine fold between 1982 and 1993, world trade of merchandise and services only doubled (de Mello, Jr. 1997). FDI is defined by the OECD (1998) as "capital invested for the purpose of acquiring a lasting interest in an enterprise and of exerting a degree of influence on that enterprise's operations". For statistical purposes, the IMF classifies foreign investment as direct when 10 percent or more of the equity of an enterprise is held by the investor (World Bank 1997). But FDI supplies a lot more than just capital. In a more general sense, FDI represents a bundle of capital stocks, technology, management know-how and other specialized skills.

The distribution of this unprecedented flow of long-term capital is far from evenly distributed. In 1997, more than two-thirds of FDI inflows went to the industrialized nations, while 90 percent of FDI outflows originates in those countries (UNCTAD 1998). Nonetheless, there is a shift occurring in favour of developing countries vis à vis inward FDI—in 1990, their share was only one-fifth of global inflows (UNCTAD 1998); in 1997, 37 percent of total FDI inflows went to developing countries (Mallampally and Sauvart 1999). Seven developing countries now rank amongst the top twenty recipients of FDI. Even between developing countries, however, FDI is far from evenly spread. South, East and South-East Asia captured 55 percent of incoming FDI going to developing countries in 1997, while Latin America and the Caribbean region accounted for 38 percent (UNCTAD 1998). Although Africa's share remains small, FDI flows to the region are significantly higher than earlier in the decade.

2.1. Factors contributing to increased FDI flows

Many factors have contributed to the unprecedented growth in global FDI flows during the past decade including a more liberalized global financial system, the need for capital and private funding for development, as well as the globalization of production.

Increased flows of long-term investments to the South are due to a number of concurrent public and private sector forces. On the public sector front, there has been a remarkable evolution in attitudes towards foreign investment within countries in the South. Historically, most developing countries imposed severe restrictions on foreign ownership in the hopes of protecting and developing domestic industry. Today's climate of financial and trade liberalization and additional investment incentives and promotion have ushered in a new era of foreign investment. Changes in the global economy have also significantly influenced FDI trends. In particular, increased competition and the growth of multinational

corporations (MNCs) have led to increases in intra-firm trade and the internationalization of production. MNCs must make strategic decisions to invest in foreign operations in order to increase competitiveness and/or expand into new markets. One way of distinguishing the factors contributing to FDI's growth is to consider the factors related to the growth in demand for FDI and the factors related to the supply of foreign investment.

Supply side factors

On the supply side, international investments and lending is currently dominated by FDI which is considered to carry lower risks than other forms of lending. Despite the Asian financial crisis in the 1990s, FDI inflows have continued to increase in Asia, even to some of the countries most affected by the crisis. This makes sense when one considers that for export-oriented MNCs which do not require many imported inputs for production, the devaluation of local currencies combined with the great need for foreign capital in the region have created a prime environment for foreign investment through acquisitions and expansion.

Trade and financial liberalization as well as advances in transportation and telecommunication have led to increased global competition. In order to compete, enterprises must develop strategies to rationalize production based on relative factor costs. Global structural adjustment and internationalization of production is occurring with labor-intensive FDI seeking low-wage countries and the integration of manufacturing affiliates into global production networks. Efficiency-seeking FDI is usually associated with production for export and intra-firm trade. On the other hand, FDI in services and primary sectors is usually driven by market-seeking and resource-seeking strategies. Foreign investment in these sectors is often the result of firms pursuing strategic positioning and expansion into new markets. Geographic proximity to new or growing markets are key determinants of FDI for firms aiming to reach new consumers.

The foreign investment strategies of firms pursuing global restructuring or strategic positioning often involve cross-border mergers and acquisitions (M&As). M&As are particularly common in the banking, insurance, chemicals, pharmaceuticals and telecommunications industries. In fact, a large part of the surge in FDI inflows in 1997 is attributable to a significant increase in majority-owned M&As in the industrialized world. These M&As accounted for nearly three-fifths of global FDI inflows in that year (UNCTAD 1998). An important outcome of this process is greater industrial concentration and fewer but larger firms in each industry.

The internationalization of production is evident in the following statistics—the value of international production rose to \$3.5 trillion as measured by the accumulated stock of FDI and \$9.5 trillion as measured by the estimated global sales of foreign affiliates. This figure includes the operations of some 53,000 transnational corporations (TNCs) and their 450,000 foreign affiliates. The percent of global GDP accounted for by foreign affiliates is 7 percent. Foreign affiliates are responsible for one-third of world exports (UNCTAD 1998).

Demand side factors

On the demand side, the shift in sentiment towards FDI from one of suspicion to one of enthusiasm in many countries in the South is concurrent with the increasing reliance on FDI to finance development as other sources of foreign capital dried up during the 1980s. In the past, domestic industries were protected through high tariffs and limited foreign investor involvement. The prevailing development strategy of the time emphasized the importance of government intervention to promote industrialization. Developing countries have spent years creating barriers to FDI in order to prevent foreign control and protect domestic firms. Restrictions on foreign ownership and regulations governing joint ownership deterred foreign investors. Controlling FDI was also achieved through outright bans in selected industries, special

approval requirements, inability to own land, burdensome taxes, equity limits, performance requirements (e.g., exporting a certain percentage of output) and local content rules. Limits on foreign exchange transfers and trade also inhibited FDI.

Since the mid-1980s, most countries have taken at least some steps towards liberalizing their FDI regulatory frameworks, particularly in export-oriented sectors in order to improve the international competitiveness of those sectors and ultimately to improve the current account balance. Restrictions on FDI for domestic market production remain largely unchanged.

The attractiveness of FDI was also bolstered by the Asian financial crisis which highlighted the fickle nature of short-term capital investments. Longer term fixed investments are now seen as far more favourable than short-term commercial loans and equity lending. As mentioned above, FDI in Asia has so far maintained its level in spite of the crisis while other forms of capital have vanished. Mexico's experience following the late-1994 peso crisis also suggests that FDI inflows often hold up much better than short-term capital, at least in the short and medium term (Thomsen 1999). It remains to be seen whether FDI will continue to grow in Asia in the longer-term.

Theoretical advances also contribute to the enthusiasm for FDI. Endogenous growth theory emphasizes the importance of human capital formation and the role of technologies in stimulating dynamic growth. According to the theory, FDI can act as a major stimulus to economic growth through the provision of scarce capital, technology and skills which are key variables in human capital formation. The predicted long-run dynamic growth-enhancing effects of FDI have motivated a growing theoretical and empirical literature on this topic.

The surge of FDI inflows to the South during the past decade was enabled by wide-ranging privatization, deregulation, regionalization, and liberalisation of foreign investment and trade regimes. But these days, countries attempting to satisfy their demand for FDI go far beyond merely liberalizing their regulatory frameworks. Increasing competition for FDI has led to various proactive measures aimed at enticing foreign firms including special investment promotions (e.g., special trade and investment zones), incentives (e.g., tax incentives) and services for foreign investors. Other variables which are not specifically related to investment but are nonetheless key to attracting FDI include: macroeconomic and political stability, ease of doing business and sound fundamentals.

Investment agreements

Continuing efforts, on the part of countries in the South, to facilitate the flow of FDI and to create favourable environments that attract FDI have spawned numerous bilateral treaties and regional initiatives. According to the UN, 1,513 bilateral investment treaties existed as of the end of 1997 (UNCTAD 1998). Regional agreements which incorporate investment are in various stages of development include: Free Trade Agreement of the Americas (FTAA), the ASEAN Investment Area and a possible new initiatives on investment within the Southern African Development Community (SADC) and the Organisation of African States.

Although there is currently no global investment policy, the Trade Related Investment Measures (TRIMs) agreement of the WTO addressed some investment issues specifically related to trade. As a result of this agreement, there has been a reduction in local content requirements. Other multilateral initiatives aimed at coordinating investment regulation include the OECD's Multilateral Agreement on Investment (MAI), currently on hold; as well as discussions which are underway within the WTO and UNCTAD.

2. Firm strategies and the globalization of production

FDI essentially reflects an investor's long-term interest in foreign production with the goal of enhancing the competitive position of the firm in a globalised economy. Is this goal compatible with developing country objectives? When and how are they divergent? To begin to answer these questions, one must have an understanding of the driving forces behind a firm's decision to become a foreign investor.

The standard explanation of a firm's decision to invest in another country utilizes Dunning's ownership-location-internalisation (OLI) paradigm (1993). According to this framework, a firm considering foreign direct investment must possess advantages significant enough to compensate for the additional costs of relocating and doing business in a different country. These advantages are:

- ownership advantage
- location advantage
- internalization advantage

The ownership advantage is a proprietary asset (a patent, product, etc.) which a firm can exploit in a new location. The firm then faces a choice. It can either produce at home and export the product, license the patent or production process to a foreign firm, or it can engage in FDI by either buying or building production facilities in the host country. If licensing is not feasible or cannot be done in such a way that intellectual property is protected, the firm has an internalization advantage—an advantage to keeping its proprietary asset internal. The choice is then narrowed to trade or FDI. The final decision between the two is determined by relative costs of production in home versus host country and/or trading costs such as import tariffs.

The OLI framework provides a simple starting point for understanding firm strategy. However, it has not stood up well to rigorous testing. For example, empirical research finds that trade and FDI are not necessarily mutually exclusive. Firms may engage in both—for example, when intermediate products are produced in the home country and exported for assembly at a foreign affiliate plant. The vertical (intra-firm) and horizontal (between countries with similar factor endowments) nature of FDI is not captured in the model. Nor does the OLI framework shed any light on the causes of the rapid FDI growth observed over the last decade.

More recent trade theories incorporating FDI are better at explaining observed patterns of firm behavior. In Markusen's "knowledge-capital" model, the location decision is based on factor price differences for vertical FDI and trade costs for horizontal MNCs (McCorriston 2000). The host country market size is also a significant factor taken into account in the model.

Mapuranga (2000) lists the potential strategies behind MNC FDI as follows:

- resources-seeking: MNC seeks access to new resources
- efficiency-seeking: MNC relocates to take advantage of lower costs and higher efficiency
- export-oriented: MNC relocates to be closer to an area into which it wants to export
- market-seeking: MNC seeks to expand in new market and avoid trade barriers
- technology-seeking: MNC seeks to be in location where advanced technologies or skills are present

Whether these objectives are compatible with the development objectives of the host country depends on the impact of FDI on the host economy, which in turn depends on the particulars of the case. The local sector's response capabilities to FDI spillovers is an important factor.

There is also a growing body of work on global commodity chains or value chains, vertical integration, and its relevance to firm strategy and FDI. Empirical studies have found that there is a high correlation between market concentration in a sector and the outflow of FDI, leading to the conclusion that FDI firms often operate in oligopolistic industries (Roy and Viaene 1998). Roy and Viaene (1998) propose that vertical control and vertical integration are important motivations for FDI. Firms strategically engage in vertical FDI in order to acquire direct control over supplies and inputs as well as over marketing and sales downstream. This trend is evident in the food and drink sector (Glover 1986); (Henderson et al. 1996); (Hobbs and Young 1999); (Royer and Rogers 1998).

Another area of research related to firm strategy is MNC mode of entry and transaction cost theory. There are, after all, many possible ways for firms to produce products in other countries. MNCs may find it cost-effective to engage in co-operative solutions and joint ventures which reduce the uncertainty of doing business in foreign markets. In many countries, having a foreign partner is required by law if not by necessity due to regulations or requirements. FDI can also take many forms. It may be a "green-field" investment or it may be a merger and acquisition.

For more in depth analyses of the theory of the multinational enterprise and how FDI decisions are made at the firm level, see Dunning (1998), Ethier and Markusen (1996), Markusen (2000), Hood and Young (2000), Kozul-Wright and Rowthorn (1998), and Svensson (1998).

3. Locational determinants of FDI

A large body of work on FDI consists of empirical studies on the determinants of FDI. The objective of these studies is to determine what country-specific factors are correlated with incoming FDI. Obviously, the ultimate goal is a prescriptive one. The assumption is that FDI is out there, and the goal is to determine what factors are important in firms' choice of a host country. If possible, government policies can then be designed to enhance the attractiveness of the country to foreign investors.

Determinants can be grouped as follows:

country characteristics	market size openness physical infrastructure distance from home country proximity to regional market natural resources
institutional variables	policies laws and law enforcement FDI-related incentives and regulations education and level of human capital
economic variables	labor costs and productivity economic and political stability

	economic growth rate level of technological development balance of payment constraints inflation
industry variables	sector size competition level of domestic protection

A common perception is that MNCs are attracted to countries with low labor costs. Noorbakhsh et al. (1999) question this assumption. Based on an econometric study covering the period 1980 to 1994 for a sample of 36 developing countries from Africa, Asia, and Latin America, they find that human capital (secondary school enrollment ratios) is a statistically significant determinant of FDI inflows, and its importance has become greater through time. There is growing evidence that MNCs look for skilled labor over cheap labor in making investment decisions.

Wilhelms (1998) considers the significance of the Institutional FDI Fitness theory which proposes that FDI is determined more by institutional variables than by fixed country characteristics. The Institutional FDI Fitness theory focuses on four areas of fitness: government, market, education, and sociocultural. Using regression analysis with data from 67 emerging economies, she finds support for the theory. She concludes that institutions, policies, and laws are far more important in attracting FDI than intransigent factors such as population size.

Some studies look at FDI inflows into specific sectors. Root and Ahmed (1979) test the significance of 38 economic, social, and political variables in attracting non-extractive, or manufacturing-based, FDI for 58 developing countries. The following factors are found to be significant and positively related to FDI: physical infrastructure, per capita GDP, GDP growth rate, economic integration, extent of urbanization, and political stability. Infuriately, none of these factors is easily manipulated by policy.

Katrakilidis et al. (1997) investigate the role of macroeconomic variables in determining levels of incoming FDI to industrialized countries during the 1980s. They find that FDI flows are sensitive to variables that relate to the dynamism of the economy, such as GDP growth rate, the wage differential between home and host country, the cost of capital and competitiveness.

Gastanaga et al. (1998) also consider the significance of institutional and policy variables on FDI inflows. A panel data set was used for 49 LCDs over 1970 to 1995. They look at the effects of corporate tax rates, tariff rates, the degree of openness, exchange rate distortions, contract enforcement, bureaucratic delay and corruption. Although the analysis is tainted with methodological problems due to collinearity of many of the variables, they conclude that policy and institutional variables play an important role in fostering incoming FDI. They find positive and statistically significant impacts from GDP growth rates, corporate tax rates exhibit a negative impact on FDI, and corruption is also negatively correlated with FDI.

Economic and political determinants are also investigated by Schneider and Frey for 80 LDCs (1985). They find that real per capita GNP has a positive effect on FDI, while balance of payment deficits have a negative effect. Aid from Western countries was also correlated with higher FDI flows.

Many country-specific studies have been conducted to determine the factors that attract FDI over time. In studying FDI determinants for China, Houde and Lee (2000) distinguish between market-seeking FDI, in other words the MNC is producing locally to sell to the domestic or regional market, and export-oriented FDI which produces for export. Their results are consistent with theory: market-oriented FDI is significantly influenced by market size and growth of the economy. On the other hand, export-oriented FDI is influenced more by factors affecting cost competitiveness such as wages and taxes.

Tsai (Tsai 1994) questions the validity of results from many FDI determinant studies which do not consider the simultaneity problem between determinants and consequences of FDI. He points out that FDI may cause a faster growing market, for instance. Using a simultaneous equation model, he finds that domestic market size and trade balance are two important determinants of FDI. Economic growth and labor cost are also important determining factors.

4. FDI impacts

Some of the potential impacts of FDI have already been mentioned above. FDI-related literature cites numerous potential FDI impacts in the host economy, both positive and negative. Three areas which have received considerable attention are: the impact of FDI on economic growth, FDI-related transfers of technology, and the relationship between FDI and trade. These impacts are considered separately below with an overview of the theories involved and summaries of related empirical work.

4.1. FDI and economic growth

The goal of growth-related research is to determine what causes growth and what policy-makers can do to increase growth rates in developing countries. There are both theoretical and empirical traditions that focus on the growth equation. This section begins with a brief description of the theory most often used to explain the relationship between FDI and growth, followed by a review of recent empirical literature that investigates the FDI-growth nexus.

Endogenous growth theory

In neoclassical growth models, growth is determined by capital accumulation and exogenous technological progress. Technology, which encompasses more than just new machinery, but also new processes, skills, and know-how, is thought to be exogenous to the growth process. Foreign capital, in all its forms, acts merely as a gap between domestic savings and investment. As such, its role is limited to a short-term boost in the level of income, leaving the long-run growth rate unchanged (1997). The reason for this result being the assumption of diminishing returns to investment.

In the mid-1980s, new models of growth were proposed which questioned the assumption of diminishing returns to investment. Specifically, investments in human and physical capital were thought to impact long-run growth positively through their effect on technological development. These new growth models are referred to as endogenous growth models since they no longer view technology as an exogenously determined variable. Endogenous growth models attempt to capture and explain the nebulous variable “technology” in order to determine what specific factors in an economy contribute to long-run growth. In these models, long-run growth rates can be altered by any factor that affects technological development. Models have focused on the role played by investments in education and research, and the impact of policies which nurture and provide incentives for innovation.

According to endogenous growth theory, FDI may play an important role in the host country’s economic growth. FDI not only brings capital, but represents a bundle of new technologies, skills, services, and even ideas. The potential for FDI-induced growth stems primarily from the possibility that spillovers from

this bundle will bring increasing returns to domestic production. FDI's benefits are greater than those of domestic investment due to these spillovers. An obvious example is FDI-related technology transfers from more technologically advanced nations to less developed ones. However, spillovers can be more broad and affect the entire economy by raising the aggregate level of human capital. This increase in accumulated knowledge enhances growth by reducing the cost of innovation (Ruffin 1993). The productivity-enhancing properties of FDI and the possibility for improving long-run growth rates have motivated a growing theoretical and empirical literature on the relationship between FDI and growth.

Empirical growth studies

The empirical growth literature began as an exercise to determine what causes growth in order to better understand the growth process itself. A multitude of empirical growth studies have been done over the past 15 years. Most of these use a growth accounting approach with an augmented production function—a simple neo-classical aggregate production function with modifications to include additional variables under consideration as determinants of growth, such as trade openness, for example. Regression analysis is done with cross-section, time-series, or panel data sets. Another standard technique is intertemporal optimisation.

Within the empirical growth literature is a subset of studies investigating the role played by private capital flows between countries. Studies on the growth effect of FDI go back at least to the 1970s. See, for example, Bacha (1974) and Bos et al. (1974).

Soto (2000) analyzed the impact of various forms of foreign private capital flows on growth for a panel of 44 developing countries during the 1986 to 1997 period. He found that both FDI and portfolio equity flows show a positive robust, and significant relationship with income growth. On the other hand, short- and long-term bank-related flows exhibit a robust negative correlation with growth when domestic banks have low capitalisation ratios. Soto emphasizes the importance of capitalised financial institutions as a precondition to realizing the benefits of financial integration.

Saltz (1992) analyzed the impact of the level of FDI on the rate of growth of GDP for 75 developing countries. He found a significant negative correlation between FDI and GDP growth rate in the period 1970-80. Although the empirical results do not support any one theory, Saltz suggests that the results may be due to the negative impacts of FDI when monopolization and transfer pricing distort factor prices in the host country. Distortions may cause an underutilization of labor resulting in a lag in domestic consumption demand. When combined with MNC monopoly power, such a drop in demand will cause output stagnation.

Some empirical studies look for potential sectoral differences in FDI's growth consequences. It has often been argued that historically FDI was not beneficial to development because it went mainly to primary sectors with very little potential for productivity spillovers. Primary sector FDI could negatively impact growth through its contribution to the deterioration in terms of trade with the North. On the other hand, foreign investment in manufacturing is expected to contribute to output growth through transfers in education, skills, and technology.

Dutt (1997) formulates a model of FDI flows from North to South which shows that FDI flowing to sectors in the South which compete with Northern production have a greater positive impact on growth than flows to sectors which compete with Southern domestic sectors because of worsening Southern terms of trade in the latter case. He further theorizes that the shift in attitude towards FDI in developing countries may be at least in part due to a change in the sectoral pattern of FDI which have enhanced the positive effects of FDI and reduced the negative ones. There have certainly been very significant changes in the sectoral patterns of FDI to LDCs. In the early 20th century, more than half of all FDI flows to LDCs

went to the primary sector, mainly mining and agricultural raw materials, while only 10 percent was invested in manufacturing. In 1990, 40 percent went to manufacturing, 50 percent to services, and 10 percent to the primary sector (Dutt 1997). However, in a cross-country growth regression of less-developed countries for the period 1985 to 1994, Dutt found no statistically significant differential effect between FDI flowing to primary, secondary, and tertiary production sectors. In fact, Dutt found a negative statistically significant effect of FDI stock on growth.

In a study on the effect of US and Japanese FDI on growth in Asia and Latin America, Poon and Thompson (1998) test the theory that manufacturing-based FDI will positively impact income growth whereas service FDI will not. They base this hypothesis on the idea that manufacturing FDI is complementary to a country's comparative advantages while service-related FDI is the result of firm-specific advantages and not related to efficient use of host country factors. They find that between 1987 and 1994, Japanese FDI to Asia has a positive impact on growth. Contrary to their hypothesis, however, they also find that US service-related FDI contributed positively to growth in Latin American countries. Their results support the theory that FDI may contribute to growth regardless of the sector into which it flows because of its impact on the general accumulation of human capital via knowledge spillovers.

Others argue that the growth-enhancing technology transfers of FDI are more likely to occur when the technology gap is smaller between home and host country. Therefore, in the case of developing countries, FDI flowing to labor-intensive industries is more likely to have a positive impact on economy-wide growth than FDI flowing to capital-intensive ones (1997). When the technology gap is insignificant, however, as it is between technologically advanced countries, the impact of FDI on growth is not expected to be significant due to the limited potential for spillovers.

In a similar vein, Borensztein et al. (1998) find in their empirical work evidence of a "development threshold"—a base level of human capital required before countries can absorb new technologies and take advantage of the potential spillovers from FDI. They develop a cross-country regression framework to test the effect of FDI on economic growth for flows from industrial countries to 69 developing countries from 1970 to 1989 based on a panel data approach for two decades. A variable representing the stock of human capital, initial level of average years of male secondary schooling, is included in the analysis. They find that FDI has a positive and statistically significant effect on growth through an interaction term between FDI and human capital. In addition, the magnitude of this effect depends on the level of human capital stock present in the host country. Countries with very low levels of initial human capital actually experience a negative direct effect on growth from FDI. This complementary effect between FDI and human capital on the growth rate of income was not evident with domestic investment.

De Mello (1997) also reports evidence of a development threshold hypothesis in his survey of FDI-growth-related literature. The statistically significant positive impact of FDI on growth is stronger for countries with a higher level of development. He postulates that a threshold level of development must be attained before a country can reap the benefits of higher productivity investment fostered by foreign investment. If the development threshold has not been reached the benefits of FDI may only impact the particular industries in which it operates.

Using a panel study including technological leaders and followers, de Mello (1999) tests the impact on growth of FDI and finds a statistically significant and positive impact for both sets of countries.

Another line of research examines the impact of FDI on growth under different policy-related environments, such as more open trade regimes. By including exports in the augmented production function, Balasubramanyam et al. (1996) find that FDI has a greater positive impact on growth in countries promoting exports compared to countries exhibiting import substitution strategies.

Compatible and reliable FDI data, which is required for cross-country regressions on FDI flows, is often nonexistent. An alternative approach to analyzing the growth-FDI relationship is with time-series information from specific countries. Such studies are useful for analyzing the particular experiences of individual economies with foreign capital.

In a study on the effect of foreign investment on Indonesia's economic growth, Asafu-Adjaye (2000) compared the impact of FDI and net private capital flows for the period 1970 to 1996. They found that FDI has a significant positive effect on growth, whereas net private capital has no significant effect.

Bende-Nabende and Ford (1998) investigate the possible links between economic growth, FDI, capital stock, technology, human capital, and government policies with a small dynamic model of Taiwan. They find that FDI has a positive effect on output.

In two empirical studies on incoming FDI flows to China, FDI is found to have a positive relationship with growth. Berthelemy and Demurger (2000) use a simultaneous-equation model estimation based on a sample of 24 Chinese provinces from 1985 to 1996 to confirm that FDI positively affects provincial economic growth. Dees (1998) also finds empirical evidence to support the hypothesis that FDI positively and significantly impacts China's growth.

Although time-series data has the advantage of enabling a detailed analysis of all the factors that may affect growth and foreign investment, there may be stationarity problems with the data. In addition, the impact of country-specific factors on the growth-FDI relationship are not observable in time-series analysis. On the other hand, these factors make cross-country studies unreliable unless they take into account all of the significant country-specific factors that affect FDI's contribution to growth in the model.

Causality between FDI and economic growth

As is the case with regression analysis, assumptions are often implicitly and incorrectly made about the direction of causality between variables. In many empirical studies on FDI and growth, a statistically significant positive relationship between FDI and growth is presented as evidence of the growth-enhancing properties of FDI in line with endogenous growth theory. On the other hand, strong arguments can be made that causality runs from output growth to FDI as well. After all, foreign investors are attracted to countries experiencing rapid growth since economic growth signifies greater opportunities for profits. Fast growing economies may be characterized by macroeconomic stability, economic liberalization, and other institutional factors which are encouraging growth. If these characteristics are also determinants of FDI, then growth may be found to cause FDI. In addition, a growing economy means rising consumer demand, and MNCs may be competing for a share of this new consumer market. The larger the market, the greater the likelihood that firms, whether domestic or foreign, can realize economies of scale. Therefore, the direction of causality between growth and FDI depends on these scale effects and on the existence of other conditions impacting growth.

Kasibhatla and Sawhney (1996) test the causality between FDI inflows and GDP growth for quarterly U.S data for the period 1970 to 1990. The hypothesis that FDI causes growth is not supported by their analysis. In fact, evidence is found for reverse causality, from growth to FDI. This result supports the theory that FDI flowing into already technologically advanced countries does not impact long-run growth through externalities. Rather, it is economic growth and associated opportunities that attract foreign investors to industrialized countries.

Using data for ten East Asian economies, Zhang (1999) examines the causal link between FDI and economic growth. FDI is found to enhance economic growth in the long run for China, Hong Kong, Indonesia, Japan, and Taiwan, and in the short run for Singapore.

Khan and Leng (1997) explore the interactions between growth, exports, and FDI for several NIEs during the period 1965 to 1995. They do not find statistically significant causality from FDI to growth for Korea, Singapore, and Taiwan. However, they do present some evidence of reverse causality from growth to FDI in the case of Singapore.

In a survey of empirical literature, Kumar (1996) concludes that the causality between growth and FDI observed in empirical studies more often runs from growth to FDI. The conflicting results of many studies is perhaps evidence of the difficulty of disentangling FDI's effect on growth from the effects on growth of FDI determinants.

Discussion

According to endogenous growth theory, the rate of technological progress is the main determinant of long run growth rates. Due to FDI's impact on technology and human capital, the growth impact of FDI should be positive for investments flowing from technologically more advanced countries to less developed countries. However, the scope of this impact depends on the amount and type of efficiency spillovers to domestic firms and other externalities associated with FDI. In many cases, there is very limited scope for technology transfers (1997) such as the case where the technological gap is wide. There is also evidence that countries must have reached a development threshold in order to realize the benefits of FDI-related knowledge spillovers. Since FDI-led growth may be limited, policy-making should focus on improving the environment for domestic investment rather than designing incentives to attract only FDI.

The conflicting empirical results of recent FDI-growth research may well reflect problems with data or the inability of models to capture the complex relationships involved. Nonetheless, these results also raises some doubt on the common assertion that FDI in all cases (and by association, financial liberalization and the opening of capital markets) positively impacts economic growth. Although it is true that FDI is less volatile than other forms of investment, and therefore does not represent a threat to economic stability, it has yet to be shown empirically and unequivocally to have a positive impact on long run growth.

4.2. FDI and technology transfer

One of the most often cited benefits of FDI is its potential to transfer advanced technology to developing countries that typically lag in their use of technology. Technical inefficiency and obsolescence translate to low productivity and also hinder efforts to improve product quality and enter into new markets (Lall 2000). MNCs bring new technologies and the skills to use them efficiently. They may also provide the skills to adapt imported technologies to local conditions.

Technological spillovers can occur through four channels. First, FDI may stimulate technical upgrading through backward and forward linkages with local suppliers and customers. Second, the demonstration effect may cause local firms to imitate foreign firms and become more productive. Third, increased competition from the MNC may force local firms to be more efficient or to introduce new technologies in order to maintain their market share. And fourth, MNCs may provide worker training in the use of new technologies thereby reducing the cost of adoption for other firms when there is labor turnover.

Empirical studies on technology spillovers

Empirical attempts at measuring the technology spillovers of FDI fall into two groups. The first group of studies try to correlate the presence of foreign firms within a sector to the productivity of local firms in that sector. The second group use production functions to analyze spillovers, typically in a case study format.

Overall, the empirical evidence suggests that sectors with higher levels of foreign involvement exhibit higher productivity, or higher productivity growth, or both (Saggi 2000). Of course, this does not necessarily mean that FDI causes an increase in productivity. In fact, as the FDI-growth relationship, one could argue that it is just as likely that FDI is drawn to sectors that tend to have higher productivity levels in the first place.

Firm-level studies provide a better opportunity to assess whether FDI is having an effect on technology transfer and productivity at the micro level. In one of the first firm-level time-series studies to explore FDI spillovers, Haddad and Harrison (1993) utilize data from the Moroccan manufacturing sector for the period 1985 to 1989. They find that foreign firms have higher levels of total factor productivity but lower rates of productivity growth than domestic firms. However, they could not link productivity growth of domestic firms in specific sectors with foreign involvement in that sector. They did not find any statistically significant evidence of technology spillover from FDI.

Aitken and Harrison (1999) analyze productivity for a panel of Venezuelan firms. They find that foreign equity participation is positively correlated with plant productivity for small firms, but that FDI correlates negatively with the productivity of domestic firms. The overall result is a weakly positive relationship between foreign investment and productivity of the entire industry.

Another positive relationship between FDI and productivity is reported by Blomstrom (1998) for micro data from Indonesia. He correlates the ownership share of MNC affiliates with productivity and finds that domestic establishments benefit from spillovers. However, the degree of foreign ownership does not affect the degree of spillovers.

On the other hand, there are several studies which find a negative or no significant correlation between foreign investment and local firm productivity. Using a panel data set at the firm level to test the effects of FDI on domestic firm productivity in Bulgaria, Romania, and Poland, Konings (2000) finds no evidence of positive spillovers in Poland and negative spillovers in Bulgaria and Romania. He concludes that the competition effect of MNC affiliates outweighs any positive technology effect.

More contrary evidence to FDI's technology transfer capacity comes from a study by the Reserve Bank of India in 1996. Jha (1999) reports that FDI has not contributed significantly to India's technological capacity or export competitiveness. On the other hand, the study also states that positive contributions of FDI may include raising total factor productivity by creating a more competitive environment leading to technological upgrading, better management and other improvements in entire sectors. Of course, this highlights the complexity in determining the overall impacts of FDI within a country.

Some researchers argue that higher transfers and spillovers are possible when certain conditions are met. For example, Kokko (1994) analyzes FDI-related technology spillovers with a panel data set from the Mexican manufacturing industry and finds that spillovers are less likely to occur in industries where large technology gaps exist between MNCs and domestic firms. Presumably, the closer the level of technological capacity between the foreign and local firms, the more likely local firms can absorb new technologies. This is confirmed by de Mello (1997) who finds that productivity spillovers are least likely to occur when the technology gap is large, such as when foreign firms are concentrated in "export

enclaves” with no significant linkages to the local economy and no competition. He also argues that higher levels of transfer and spillovers are possible when the level of education is higher in the host country, when the competition with existing firms is greater, and when there are fewer legal and institutional barriers to operation. Industry-specific characteristics such as the degree of concentration appear to be more dominant than country-specific factors in determining technological transfer and the scope of productivity spillovers from FDI (1997).

The importance of a threshold of technological capability and the importance of competition are further supported by the findings of Kinoshita (1999) and Blomstrom and Globerman (2000). Kinoshita looks at technology spillovers using 1990 and 1992 firm-level data in China and finds that technology spillovers are accelerated when local firms train skilled workers. In a review of literature on the determinants of efficiency spillovers from incoming FDI, Blomstrom and Globerman find that competitiveness of host country markets and the technical capability of local firms are two of the most significant determinants of spillover benefits. This finding is also consistent with some of the trade-growth literature—that is, a threshold level of human capital, in this case proxied by the technical capability of local firms, must be reached before FDI benefits flow to the domestic sector.

Intellectual property rights may also play a role in capturing spillovers. In survey on trade, FDI, and international technology transfer, Saggi (2000) stresses to the importance of intellectual property protection as a factor in ensuring technology spillovers from FDI.

Discussion

Many researchers are reconsidering the underlying theory behind technology transfer and FDI, and how theory relates the past empirical work, due to the lack of consistent empirical results showing a positive correlation between FDI and technology spillovers to local firms. Saggi (2000) suggests that the period of time used in existing studies may not be long enough to show accurate results. An adjustment period is needed after entry of a foreign firm when inefficient domestic firms are weeded out by the increase in competition. He argues that eventually, the reallocation of resources will lead to greater sector productivity.

Kugler (2000) presents a simple yet powerful explanation for why previous empirical work has failed to show spillovers from FDI. He points out that most studies focus exclusively on *intra*-industry externalities. However, the theory of the multinational firm states that an MNC locates in a foreign country in order to minimize the risk of losing profits due to diffusion of technology and information to competitors. The additional transaction costs of moving and setting up in a foreign country must be compensated by a competitive advantage. Therefore, spillovers from FDI are more likely to be *inter*-industry and not involving direct competitors. Beneficiaries of spillovers are likely to be firms which have upstream or downstream linkages with the MNC, for instance. The MNC in these cases has a self-interest in helping firms reduce costs upstream in order to reduce input costs. Other beneficiaries of FDI spillovers may include producers from other sectors who gain from the diffusion of generic nonproprietary technologies brought in by the foreign firm. Kugler finds support for his theory of inter-sector spillovers in a multisector model of FDI technology transfer with Colombian manufacturing data. Spillovers to local firms that compete with MNCs are least likely to occur.

Others also suggest that certain channels of technology transfer may be more important than previously thought. For example, diffusion through labor turnovers may be a highly significant means of technology transfer. Technology transfer through labor turnover will occur only when local firms have the ability to absorb technologies introduced by MNCs (Glass and Saggi 1999), which is consistent with the finding of a technological absorption capacity requirement. On the other hand, MNCs want to prevent labor turnover

in order to protect their competitive advantage. They can do this by paying higher wages than local firms. Effectively, higher wages from MNCs limits technology diffusion.

The mixed empirical results relating to FDI technology transfer suggest that the phenomenon varies a great deal across countries and sectors. The relationship between foreign firms and domestic economic development is complex and dynamic. The theories that have emerged recently in the literature to explain the lack of empirical evidence need to be explored fully with detailed case studies over longer periods of time in order to capture the changing environment in which FDI operates.

4.3. FDI and trade

Globalization has coincided with large increases in the international movement of goods and capital. Global growth of trade and FDI has been strong, although since the mid-1980s, the growth in FDI has surpassed that of trade. In fact, the value of global production by MNC affiliates now exceeds the value of total world trade, suggesting that FDI production is the dominant means by which foreign markets are served (McCorriston 2000). The globalization of production through FDI and its relationship to trade is a key area of interest for researchers and policy-makers alike. This section begins with a discussion of one of the most researched subjects in the FDI-trade nexus: the question of whether trade and FDI are substitutes or complements. This is followed by a review of some theoretical and empirical work related to the trade-FDI dynamic. This section concludes with a discussion of export-enhancing FDI and development.

Trade and FDI: Substitutes or complements?

The question over whether FDI and trade are substitutes or complements has a long history in the economic literature. The concern is mainly one of the investor countries, in other words the industrialized countries. Their fear is that domestic firms will move their operations abroad instead of exporting thereby hurting domestic production and employment. In summary, the substitution hypothesis is that production relocation reduces the scope for trade between the MNC home country and MNC affiliate countries. Early literature on MNC behavior supported this hypothesis. FDI and trade were seen as either/or alternatives for a firm in the international organizational theory literature as well as in traditional trade theory.

On the other hand, there are two possible explanations why FDI and trade may be complementary. First, there may be vertical relationships between the MNC in the home country and its affiliates such as trade in intermediate goods and other inputs which increase home country exports. This is likely if capital-intensive inputs are required for production, as is the case in the automobile manufacturing sector. FDI and trade may be substitutes in terms of the end product, but complementary in terms of intermediate goods. Second, there is the potential for demand complementary whereby MNC affiliates abroad establish markets for other goods. For example, the affiliate may develop brand recognition or establish marketing facilities which lead to an increase in the demand for other products produced in the home country. Aggregate home country exports may increase under this scenario.

Another possibility is that exports precede FDI, therefore they are complementary over a period of time. This makes intuitive sense: a firm establishes a market overseas through exports, and then when economies of scale can be realized, it relocates production to the host country. Optimal relocation theory tries to predict the timing of advantageous relocation.

Theoretical modeling of FDI and trade

During the last few years, great strides have been made in integrating the theory of the multinational enterprise into international trade theory. This has been possible with newer trade theories which relax the assumptions of constant returns to scale and perfect competition. New models incorporate country and

firm characteristics in the assessment of the advantages and disadvantages of investing in foreign production versus engaging in trade. A full review of this work is beyond the scope of this report. For a detailed discussion of the latest theoretical developments related to incorporating MNCs into formal general-equilibrium models, see Markusen (2000) and McCorriston (2000).

Traditional theories explaining FDI flows fail to account for the explosive growth of FDI which began during the 1980s, and do not provide adequate explanation for the patterns of FDI observed in the real world. In contrast, recent models such as what Markusen calls the “knowledge-capital” model have been very successful at explaining the observed patterns of trade and FDI—such as the observation that as with trade, most global FDI occurs between countries with similar factor endowments and much of it is intra-industry investment. Empirical studies have shown strong support for the “knowledge-capital” model.

Empirical studies on trade and FDI dynamics

An OECD-supported report which synthesizes some of the recent work on the relationship between FDI and trade concludes that the relationship is complex and cannot be inferred from theory (Fontagné 1999). Using a database of bilateral trade flows and FDI for a set of 14 countries, the study finds empirical evidence that trade generated FDI until the mid-1980s, after which FDI is found to generate trade. More specifically, foreign investment abroad stimulates exports from the home country. In host economies, incoming FDI has a short term negative impact on the trade balance due to an increase in imports. In the long-run, however, exports increase. The conclusion is that the nature and extent of the relationship between FDI and trade, including whether they are substitutes or complements, differ from one country to another.

A review of empirical literature by Fontagne concludes that at the macroeconomic and sectoral level, empirical studies generally support complementarities between FDI and trade (Fontagné 1999). McCorriston (2000) also notes that generally trade and FDI have been found to be complementary in the empirical literature.

In 1994, Hufbauer et al. (1994) assess the effects of FDI stock on merchandise trade for the United States, Japan, and Germany. They find inconsistent results across countries and time periods. Japan is the only country where outward FDI consistently raises imports more than exports.

Goldberg and Klein (1998) focus on trade and FDI between the US and Japanese investments in Southeast Asia and Latin America. For the period 1979 to 1995, they find a full range of effects and conclude that it is not possible to make any systematic conclusions from their analysis.

The complementary hypothesis that outward FDI boosts exports is tested for Taiwan by Lin (1995) who finds that outward FDI does indeed have a positive impact on exports as well as imports between Taiwan and four ASEAN economies. He proposes that FDI enhances bilateral trade because MNC affiliates require imported intermediate goods and other inputs in the production process.

Clearly there is no consensus on a definitive relationship between FDI and trade at the aggregate level. When one considers the complexity of the relationship between FDI and trade, including country-specific, industry-specific, and firm-specific factors, it is no wonder that no consensus exists. Unfortunately, one problem with studying the relationship between trade and FDI is the lack of disaggregated data. Often, only country or sector-level data is available. Firm-level and even product-level studies produce the most accurate analysis of the dynamic between trade and investment in specific cases. As McCorriston (2000) concludes, better data is sorely needed to enable more systematic empirical research to test hypotheses about FDI dynamics and behavior.

Export-oriented FDI in LDCs

One of the most debated issues related to trade and FDI in developing countries is whether inward FDI contributes positively to export growth. In light of the success of newly industrialized economies and their reliance on export-led growth, many developing countries are actively pursuing export-oriented FDI with special incentives or export performance requirements. However, despite the prevalence of policies to attract export-oriented FDI, empirical studies are not consistent in showing a positive relationship between FDI and the expansion of manufactured exports from LDCs.

At the country level, the impact of inward FDI on exports can be measured in terms of the direct contribution of foreign-owned firms to export volume, or in terms of significance of the FDI spillover effect on export intensity changes in the host economy (most likely in the same industry as the FDI). If the goal of encouraging export-related FDI is to jump-start labor-intensive, export-oriented production and growth, then spillovers and linkages with domestic firms must be present. Otherwise, exporting MNCs merely represent an export enclave without any dynamic impact on export-related growth.

In an empirical study of the spillover effects of inward FDI on export growth in Zimbabwe, Mapuranga (2000) finds evidence of a positive spillover effect between inward FDI and export growth of firms and sectors engaging in pre-export technology processing. However, a negative effect in the primary industry activities is observed. The results indicate that there is more opportunity for enhancing domestic manufacturing export growth through foreign investment than in extractive industries.

In the case of Sri Lanka, Athukorala (1995) finds that much of the export dynamism experienced is due to foreign investment. However, there remains high import requirements and limited technology transfer and backward linkages to domestic firms. Athukorala postulates that this is due to the fact that export-oriented FDI is still in its early stages. He also warns that the results are not generalisable to other countries. Both the level of industrial development and the policy environment were two country-specific factors which played critical roles in reaping the benefits from export-enhancing FDI.

In conclusion, the impact of FDI on export expansion varies across countries depending on the degree of technological development, the level of human capital, and the institutional environment. Therefore, programs and policies to attract export-related FDI may not be enough to realize the potential export-enhancing impacts of FDI on the economy as a whole. If there are low levels of domestic investment, for example, the domestic response to FDI spillovers and externalities may be minimal.

4.4. Other FDI impacts

There are many other potential host country impacts considered in the literature, including impacts on:

- employment and wages
- local skill level (human capital) and other spillovers
- access to world markets
- terms of trade
- market structure, industrial restructuring
- domestic firms (profit squeeze versus competition enhancing)
- research and development activity
- infrastructure
- factor productivity
- domestic savings and investment (crowding out versus crowding in)
- intellectual property rights and patents

- labor and environmental standards
- environment
- inequality (income; regional disparities)
- regionalization
- capital account, foreign exchange earnings, exchange rate

A review of the literature concerning these impacts is beyond the scope of this report. For more information, refer to the Appendix for a list of related articles.

5. FDI-related public policy issues

Until recently, the consensus in international development circles was that FDI generated positive spillovers and benefits for host economies. Governments were encouraged to actively promote foreign investment so that they would not be left behind as technological laggards. However, the empirical evidence to prove conclusively that FDI's impact is positive remains elusive. Current academic literature is much more skeptical about claims that FDI has a net positive impact on welfare (Hanson 2001). It is therefore no surprise to find that there is no consensus on what role, if any, host governments should play in either promoting FDI in general or in regulating FDI in accordance with a country's economic development strategies. Researchers and policy-makers addressing these questions range in their viewpoints from those promoting a "hands off" pro-liberalization position to those arguing that only through government intervention and proactive policy-making can LDCs bargain successfully with foreign investors and ensure that FDI's impact is beneficial overall.

Given the mixed empirical evidence on FDI's impact on growth, trade, and technology transfer, it is understandable that many countries remain cautious in their attitudes and policies towards FDI. In addition to the empirical ambiguity, recent theoretical work highlights the potential market failures in the investment process (Lall 2000). When market failures are present, the welfare effects of FDI can be negative for the host economy. Lall (2000) outlines four issues of concern for host government policy:

- information and coordination failures in the international investment process
- infant industry considerations in the development of local enterprises
- static nature of spillovers from FDI (one-time boost through transfer of technology and skills rather than the desired dynamic transfer of skills and upgrading over time)
- weak bargaining and regulatory capabilities of the host government

There are many areas in which governments can potentially play a role in addressing these issues and ultimately in affecting the impacts of FDI. These include:

- industrial and trade policy
- foreign investment policy (incentives and regulations)
- legal and regulatory frameworks (intellectual property rights, environmental and labor standards)
- competition policy
- tax policy
- international investment agreements (what's needed? what's appropriate?)
- development policy

Development policy is worth re-iterating. The importance of host country human capital development is a reoccurring theme in FDI-development literature. Investments in education, training, research and development raise the level of knowledge and the absorptive capacity of the economy so that it may

maximize gains from the presence of FDI. In addition, host country characteristics such as technological capacity and available skills are key determinants in the location decisions of MNCs.

6. Country and regional studies

Country and regional studies form a large component of the literature related to FDI and development. There are several major threads:

- NIEs and the role played by FDI in their growth and development
- the role of FDI in emerging and transition economies
- the impact of FDI on China, consistently the largest developing country recipient of FDI (UNCTAD 1998)
- the links, if any, between FDI and the Asian financial crisis of the 1990s

The empirical and theoretical work on the NIEs is particularly interesting for its policy implications. Many NIEs maintained very restrictive policies on foreign investment during their rapid growth periods. Some claim that their controlling policies on FDI enabled their successful transition to industrialization.

7. Conclusion

Empirical research thus far offers little support for indiscriminate FDI promotion. Nonetheless, globalization trends continue and LDCs as a whole rely increasingly on private foreign capital and technologies for their development. There clearly is a need for more research on the consequences of FDI and the dynamics between foreign firms, local industry, and the globalization of production. A common theoretical base and reliable, accurate, and consistent data are needed so that quantitative analysis can be done along with case studies of the impacts of foreign investment in different sectors and under various conditions.

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