Direct Investment Among Developed Countries: Lessons for the Developing World

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Among development economists and public officials in the developing world, interest in foreign direct investment (FDI)[1] has staged a revival. Perhaps because of disillusionment with other forms of capital inflow, perhaps because of the lack of commercial long-term debt finance since the early 1980s, perhaps because of changing fashions in official development assistance and the rhetoric of aid agencies, most developing countries now claim to welcome FDI. Yet the virtues for which FDI is extolled — technology transfer, export promotion, access to foreign exchange — echo the language that was used to judge it 20 years ago. This language reflects an outmoded perspective that bears little resemblance to that of the major investing countries (and companies) today.

Contrary to popular perceptions in the developing world, the bulk of foreign direct investment takes place within the industrialised countries. For them the decade of the 1980s has seen a boom in FDI. Like trade, FDI is regarded as a two-way flow, with most of the major providers also being the major recipients. However, while trade in the 1980s grew by less than five per cent annually, FDI flows have grown by over 20 per cent per year since 1983.

Most of this growth has bypassed the developing countries. Two-thirds of the total world stock of FDI is held by just three countries: the United States, Britain and Japan. Adding Germany and France to form a 'group of five' (G-5) accounts for more than 75 per cent of the world FDI outflows. On the inflow side, over the 28 year period from 1961 to 1988, FDI into the G-5 (from all sources) amounted to over half of the FDI they provided to the rest of the world. During the boom years of the 1980s this pattern intensified. The ratio of G-5 inward investment to G-5 outward investment rose to 0.75.

The disparity of FDI flows in the developed and developing worlds is striking. Not only have the developing countries shared disproportionately little in the FDI boom of the 1980s, but the absolute amount of FDI they received was actually lower in real terms in the 1980s than it was in the 1970s. If developing countries wish to increase their share of global FDI flows in the 1990s, they may benefit from studying the trends and the underlying conditions relating to the rapid increase in FDI that has taken place in the advanced economies during the 1980s.

This paper summarises the results of a research project carried out at the Royal Institute of International Affairs in 1986-89 to study the factors behind the surge of FDI among developed countries.[2] Section 1 describes recent trends in FDI from an international perspective. Section 2 discusses the parallel between FDI flows and trade flows, both in their underlying motivation and in their links to growth. The final Section suggests lessons for developing countries that wish to participate in the anticipated increase in such private cross-border flows in the 1990s.

1 FDI Flows in the 1980s

It is useful to set the development of G-5 FDI during the 1980s into its broader historical and geographical context. Figure 1 shows annual aggregate flows of FDI into and out of the G-5 since 1961. The wave pattern of surges and retrenchments is evident at this aggregate level, as are the extreme heights that have been reached in the last few years.

These years of FDI peaks and valleys coincide with trends in economic growth and recession in the industrialised countries. A simple regression relating real FDI growth and real GNP growth for the five countries in aggregate over a 25 year period yields the following parameters:[3]

[1] The IMF defines direct investment as 'investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise'. Most countries use 10 per cent ownership as the practical minimum for having an 'effective voice' in management, with smaller purchases of equity considered portfolio investment. Profits retained in the foreign subsidiary should also be counted as FDI, but Japan and France do not follow this convention. Because of definitional differences all data cited in this paper and all cross-country comparisons made should be regarded as indicative rather than exact.

[2] A more complete discussion can be found in Julius [1990], which is also the source for all cited data. Original data sources are national publications from the five countries. Country-specific growth rates are calculated in domestic currency; cross-country aggregations use average period exchange rates. Real figures are in 1980 prices.

[3] T statistics are shown in parentheses. The correlation coefficient, R-squared, is 0.53.

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$$FDI = -0.06 + 3.44\ GNP$$
$$(-0.33) \quad (5.23)$$

where FDI = percent change in real FDI by the G-5
GNP = percent change in real GNP of the G-5

This equation suggests that FDI growth mirrors GNP growth but has increased over three times as fast since the early 1960s. When the same regression is run separately for two sub-periods, the GNP coefficient increases from 3.01 in 1963-79 to 3.65 in 1979-88, a statistically significant change. This reflects the stronger upsurge in FDI, relative to the growth of income, during the 1980s.

The pattern of FDI in the 1980s is one of strong and sustained recovery after a fall in the early part of the decade due to worldwide recession and the aftermath of the second oil shock. In real terms, FDI outflows from the G-5 in 1988 were nearly 40 per cent above their previous peak of 1979. As shown in Figure 2, the United States and Britain — the world's largest direct investors — recorded increases in real terms of over 15 per cent since 1983. Japan and France, starting from much lower bases, increased their FDI at more than 30 per cent per year.

Figures 1 and 2 also illustrate the relationship between inflows and outflows among the G-5. The US and the UK were the largest 'importers' as well as 'exporters' of FDI during the 1980s. A similar pattern occurs with trade flows, where the world's five leading exporters (in 1988, Germany, US, Japan, France, UK) are also the five largest importers (US, Germany, UK, Japan, France). However, FDI is still a much more concentrated phenomenon than trade. Whereas the G-5 account for over 75 per cent of global FDI flows, they provide just 42 per cent of world merchandise exports. This difference has implications for the future growth of FDI flows, as discussed later in this paper.

Within the G-5 there has been a major shift in direction and increase in dispersion of flows since the 1960s. These developments broadly reflect underlying changes

Figure 1 **Aggregate outflows/inflows of FDI by the G-5 (US$bn)**

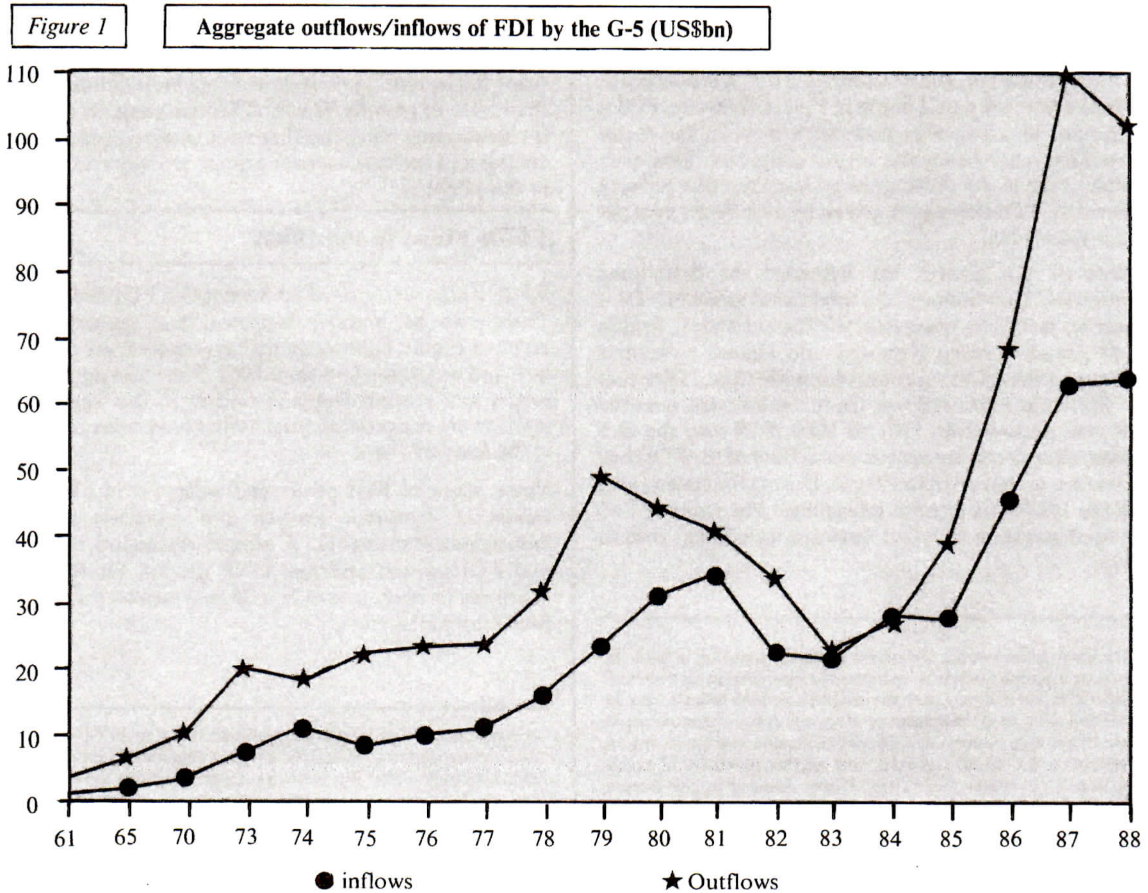

Figure 2

Summary of G-5 foreign direct investment

	Outward			Inward
	Stock (1988) $ bn	*Real Growth in Flows (1983-88) % pa*	*Total Flows*	*Total Flows*
			--- *(1980-88)* --- *$ bn*	
US	324	20	157	252
UK	184	16	138	65
Japan	114	37	96	3
Germany	78	15	52	9
France	57	32	43	28
Total	757		486	357

in the world economy. Between 1960 and 1975 only the United States was a significant **net** exporter of FDI. Its net outflows (i.e. US FDI outflows less inflows into the US) reached 79 per cent of the total G-5 outflows in 1966. Britain and Japan were also net outward investors during this period, but in amounts that paled in comparison with those of the US. France and Germany were net importers of FDI.

After the strong rise in prices of oil and other commodities in 1973, all of the G-5 countries except France became large net exporters of FDI. This reflected their desire to secure supplies of oil and certain other raw materials, and also showed the enhanced profitability of investment in energy resources. The international oil companies were already major foreign investors, and they were able to respond quickly to the stimulus for increased investment brought about by the fourfold increase in international oil prices.

By 1980 the commodity price boom had peaked and its effects had sown the seeds of the world recession that took hold in 1981. That was also the year when the earlier trends in FDI flows by the G-5 culminated in a reversal of net flows for the United States. For the first time in many decades, the US experienced a net **inflow** of FDI. It has been a net recipient ever since, although in most years it remains the largest FDI exporter.

At the same time as the US became a net recipient of FDI, France reversed its net position and became a net FDI exporter. Meanwhile Britain and Japan greatly increased their net FDI positions; Britain because of large outflows, Japan because of a combination of growing outflows and negligible inflows.

Such **net** statistics on FDI reveal little about its underlying causes. It is too simplistic to link FDI flows to current account deficits or surpluses. While Japan has been a major source of FDI outflows during its period of current account surplus, the United Kingdom has provided even larger outflows while it has been running a current account deficit in excess of 3 per cent of GNP. Further, a focus on net annual flows obscures two important economic features of FDI: first, the striking surge in **total** flows during the 1980s (as noted above) and, second, the subsequent importance of the foreign-owned firm (FOF) to the host economy after the initial investment has taken place. It is the explanation of these two aspects to which we now turn.

2 Foreign-owned Firms and Trade

From the point of view of a firm, there are essentially two ways to reach a foreign market: through trade and through foreign investment. If the firm wishes to use foreign inputs, it can either import them into its home country or it can set up (or buy up) a local company in the foreign market and produce its product there. Similarly, if it wishes to sell to foreign consumers, it can either export its product to them or it can set up a foreign subsidiary in the host country and sell directly. Often it will use a combination of trade and FDI, and this combination will evolve over time — generally towards moving more of its production closer to its ultimate consumer — as the FOF becomes adept at operating in the host market and learns to use local suppliers and factors of production.

This evolution of trade into direct investment is what accounts for the close correlation between a country's major trading partners and the countries in which it has the bulk of its direct investment. In terms of direction of flows, trade and FDI are primarily complements, not substitutes.

This essential complementarity between trade and investment provides an important clue to what lay behind the surge of FDI in the last decade. More than half of the FDI outflows from the G-5 took place in the service industries. For both structural and regulatory reasons, trade is often limited in services. Many service businesses require contact between the seller and the buyer, (e.g. hotels). For a company in those businesses, international expansion requires investment. In other services, such as banking or telecommunications, regulatory barriers have stood in the way both of trade and foreign investment. An important change in the policy environment for FDI in the 1980s was the deregulation of service industries in the US, Europe and Japan.

Figure 3 shows that the stock of service sector FDI nearly tripled between 1980 and 1988. For the five countries together, it grew from 34 per cent of the total FDI stock in 1980 to 42 per cent in 1988. The service sector has been to FDI growth in the 1980s what oil was in the 1970s. But whereas the oil industry was already internationally diversified and globally competitive at the beginning of the 1970s, that process is just starting for many of the service industries. And whereas oil consumption accounts for less than five per cent of expenditure in advanced economies, services account for more than 60 per cent. The scope for further FDI growth is thus significant.

The importance of service sector deregulation as a stimulus for FDI during the 1980s (and continuing into the 1990s) is fundamental to understanding its role in economic integration. As economies develop, their centre of gravity shifts from agriculture to manufacturing to services. Along the way, international linkages develop within the predominant sectors leading to specialisation and trade. Thus, in the 18th century when Adam Smith was writing, most international trade consisted of raw materials and agricultural products. These were also the sectors of the domestic economy that employed most of the labour force. It was therefore natural to think of land and labour as the key elements of comparative advantage.

By the time the GATT was set up in the middle of the 20th century, manufacturing had become the predominant sector and the fastest growing part of international trade. The most successful developing countries were those that were able to diversify their exports away from commodities into manufactures, for which world trade was relatively open and buoyant. Today the service sectors have become both the largest and most dynamic part of advanced economies. It is natural that international competition is developing in those industries, and for many of them direct investment is a more effective route to foreign markets than trade.

This conceptual similarity between trade and direct investment means that both tend to grow faster than GNP during times of economic expansion. It is also why increased FDI — like increased trade — provides its own impetus to further growth, through the dynamic gains of extending the bounds of competition within countries and the static efficiency effects of economies of scale. The advanced countries may have already entered an era of FDI-led expansion analogous to the trade expansion of the 1950s. The tariff reductions that spurred trade in goods during the post-war period are paralleled by the deregulation of service industries in the 1980s. Trade expansion was helped in the 1950s by the shift to convertible currencies. The corresponding financial market impetus to FDI in the 1980s was the global linkage of money and capital markets. This permitted a smoother transfer of global savings among countries — aided by flexible exchange rates — and a wider array of options for companies to raise finance for investment wherever they chose. And just as trade liberalisation in the 1950s was a powerful force for growth through improved efficiency in sectors facing import competition, so FDI is playing a largely unacknowledged role in stimulating the efficiency gains at the firm level that have resulted in the sustained economic growth enjoyed in most of the OECD during the 1980s.

Figure 3

Stock of service sector FDI by outward investor
($ bn)

	1980	*1988*
United States	62.5	132.8
United Kingdom	23.7	71.8
Japan	5.1	66.1
Germany	9.2	24.2
France	7.4	22.8
Total	107.9	317.7

An important dimension in understanding FDI as a vehicle for economic integration and growth is the role that foreign-owned firms play in their host economies. The FDI itself, after all, is only the initial vehicle through which firms establish themselves abroad. Of much more economic significance are the flows of local sales and purchases of the FOFs in their host countries. Not only are these sales and purchases much larger than the initial FDI flow. but they generally continue and grow for many years after the investment takes place.

Even after the major growth of FDI in the 1980s,

global FDI is roughly one-tenth the size of world trade. However, that is not comparing like with like. Exports and imports are analogous to the local sales and purchases of FOFs, not the one-shot FDI injection. How large are these local sales and purchases? The data are limited, but it appears that they are already a more important way of reaching foreign markets than are imports and exports for many firms in the OECD countries. For the United States, for example, Figure 4 compares the local sales by US-owned firms abroad with US exports to the same countries. In seven of its ten biggest export markets, US subsidiaries in those countries sell more locally than the US exports to them. Total 1987 sales by US-owned firms abroad were more than double US exports. And, on the import side, US consumers purchased one and one-half times as much from FOFs located in the US than they bought via imports.

Even these figures understate the importance of FOFs in reaching foreign markets because about 30 per cent of US exports go to US affiliates abroad. This explains two of the three exceptions in the top ten of Figure 4: as popular offshore production bases for US firms, neither Korea nor Taiwan would make the list if of top ten US export markets it were not for the exports of US parents to their subsidiaries in those countries. In turn, those subsidiaries are responsible for a large part of the export success of their host countries in the US market.

The links between FDI and trade are clear. For many of the developed countries, the local purchases and sales of foreign-owned firms are already more important than trade in their companies' international competitive success. For developing countries, trying for export-led growth while excluding foreign investment is competing in world markets with one hand tied behind the back.

3 Lessons for Developing Countries

The varying success of developing countries in the 1980s also lends support to the idea of a two-way linkage between FDI and growth. For them the foreign exchange constraints to growth provides an additional dimension to the parallel role of FDI and trade in 'leading' growth. Figure 5 shows the starkest comparison between ten major Latin American countries — who grew at an average annual rate of 2.5 per cent between 1984-89 and received FDI of 0.7 per cent of GDP — and five Asian developing countries — who grew by 4.7 per cent per year over the same period and attracted FDI equivalent to 1.5 per cent of their GDP.

Obviously there were many factors besides direct investment that contributed to the success of the Asian LDCs, and to the problems of the Latin American ones. Development economists have long lauded the

Figure 4 **US exports and local sales by US affiliates abroad**
($ bn, 1987)

	US exports to:	*Local sales of US firms in:*	*Ratio*
Canada	59.8	100.00	1.67
Japan	28.3	36.7	1.30
Mexico	14.6	7.0	0.48
UK	14.1	88.1	6.24
Germany	11.7	61.4	5.27
Netherlands	8.2	15.2	1.85
Korea	8.1	0.7	0.08
France	7.9	42.3	5.32
Taiwan	7.4	1.7	0.23
Benelux	6.2	10.2	1.75
All countries	254.5	537.9	2.11

importance of trade linkages and an export-oriented development strategy. But the role of FDI in establishing those trade flows has not been widely recognised. In 1982, when Singapore's export success in the US market was at its zenith, 47 per cent of those exports were by US-owned firms in Singapore. In the same year, 52 per cent of Malaysian exports to the US were from US affiliates. Taiwan's five leading electronics exporters are US-owned firms. These Asian countries are about to enjoy another wave of export success, but this time on the back of the heavy Japanese FDI they have been receiving. A developing country that can harness its economy to the twin engines of FDI and trade can multiply its prospects for growth.

The conditions needed to attract FDI are not hard to identify, but they may be hard to achieve. Most important is a stable, low-inflation, macroeconomic environment. Without this neither foreign nor domestic investors will want to commit long-term funds. Second, foreign exchange regulations must permit profit and capital outflows as well as inflows at a reasonable exchange rate. Again, this is also important for domestic savers and investors who will otherwise find avenues for capital flight. The next step for encouraging inward FDI is to re-examine the rationale for prohibiting foreign investment in certain sectors. Typically there are many of these ranging from minerals to electricity to banking. Often they are controlled by inefficient public sector monpolies. Allowing foreign (and domestic) competition, with or without privatisation of the national monopoly, can bring substantial gains in the efficiency of capital used in the sector, as well as the obvious financial benefits

Figure 5

FDI in selected developing countries
(1984-89)

	10 Latin American LDCs[1]	*5 Asian LDCs*[2]
FDI/GDP (%)	0.7	1.5
FDI/net external borrowing (%)	59	106
GDP growth rate (% pa)	2.5	4.7

[1] Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, Uruguay, Venezuela.
[2] Indonesia, Malaysia, Philippines, Singapore, Thailand.
Source: Institute of International Finance, Inc., 1990.

of FDI. Finally, the foreign investor will want to be assured of 'national treatment' once established in the host country — the principle that a foreign-owned firm will have the same legal and commercial rights and responsibilities as a domestic firm. It must follow the same laws as its domestic competitors, but it will also be protected by them.

Note that all these conditions should be met in such a way as to benefit domestic investors at least as much as foreign ones. Setting up special 'investment promotion' offices to aid foreign companies in obtaining import licenses, to negotiate special tax holidays, etc., is likely to discriminate against domestic firms. It is also likely to be either ineffective — in the absence of the conditions above — or unnecessary — if those conditions have been met.

The experience of the developed countries in the 1980s points to an increased role for FDI in fuelling growth and economic integration in the 1990s. Direct investment — like trade — is a positive-sum game. Further increases in global flows are projected, especially in the rapidly growing service industries. But only a few developing countries are likely to share in the benefits. The obstacles to inward investment are mostly self-imposed ones whose removal would increase domestic investment as well as foreign. Recognising the central role that FDI has gained in the advanced countries may help to permit such policy changes to be considered on their merits in the developing world.

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