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FOREIGN DIRECT INVESTMENT FLOWS TO LOW-INCOME COUNTRIES: A REVIEW OF THE EVIDENCE

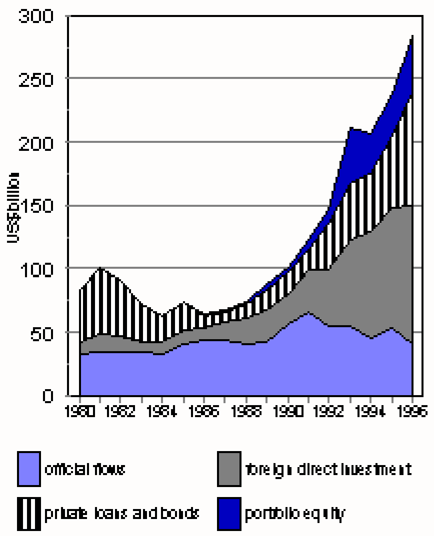
Foreign direct investment is viewed as a major stimulus to economic growth in developing countries. Its ability to deal with two major obstacles, namely, shortages of financial resources and technology and skills, has made it the centre of attention for policy-makers in low-income countries in particular. Only a few of these countries have been successful in attracting significant FDI flows, however. This paper reviews the recent evidence on the scale of FDI to low-income countries over the period 1970-96 and major factors determining foreign companies' decisions to invest in a particular country.

Steady growth of FDI flows

From the early 1970s, net resource flows to developing countries have followed an uneven path, but have risen rapidly since 1986 to an unprecedented US$285 bn in 1996. The fluctuating nature of private capital flows has played a key role in this. Whereas official flows have continued broadly unchanged after a peak in 1989-91, private capital flows have experienced two waves of explosive growth, the first from 1975 to 1981, dominated by bank lending involving a high proportion of recycled petro-dollars, the second since 1990, dominated by foreign direct investment.

In the 1970s, FDI made up only 12% of all financial flows to developing countries. Between 1981 and 1984 there was a sharp fall in private lending (see Figure 1), as international banks lost confidence in borrowing countries' financial stability following the debt crisis of 1982. Since the mid-1980s the growing integration of markets and financial institutions, increased economic liberalisation, and rapid innovation in financial instruments and technologies, especially in terms of computing and telecommunications, have contributed to a near doubling of private flows. Most significant has been the steady progression of FDI to a 35% share in 1990-6. Portfolio equity has also emerged as an important component of global private flows - 13.5% of total flows in the 1990s in contrast to a mere 1.2% in the 1980s.

Figure 1: Net Resource Flows to Developing Countries (US$bn)



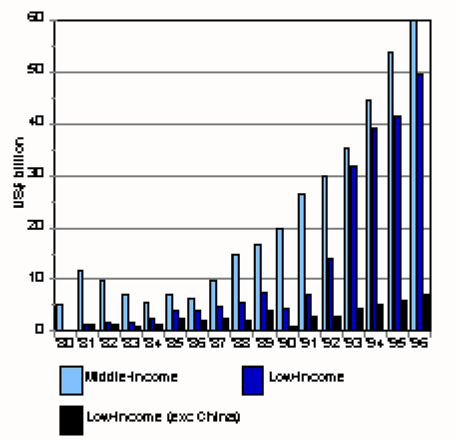
Notes:
Official Flows: including official grants and loans from bilateral and multilateral organisations.
Foreign Direct Investment: investment made to acquire a lasting management interest, usually at least 10% of voting stock, in an enterprise operating in a country other than that of the investor.
Private Loans and Bonds: loans from private banks and other financial institutions and privately placed bonds.
Portfolio Equity Flows: the sum of country funds, depositary receipts (US or global), and direct purchases of shares by foreign investors.

Sources:
World Bank, *World Debt Tables* 1988-1996, *Global Development Finance* 1997

FDI to low-income countries

An examination of net private capital flows by income group reveals the fluctuating nature of those to middle-income countries which were severely affected by the debt crisis of 1982, and to a lesser extent by the 1994 Mexican crisis. Low-income countries, on the other hand, have seen a smoother rise in inflows of private capital. Most of them were less affected by the debt crisis, because of their low level of commercial bank loans, due, in part, to their previously closed economies and their lack of suitable financial markets. It was only towards the end of the 1970s that those in Asia in particular began to open their doors wider to foreign capital. Figure 2 shows FDI flows to both middle- and low-income countries were still relatively modest at the beginning of the 1980s, some $US5 bn, and accounting for only 19% of all private capital flows to low-income countries in 1981. By 1996 this figure had risen to 74% (in comparison with 34% for middle-income countries).

Figure 2: Foreign Direct Investment by Income Group (US$bn)



Notes:
Low-income countries: GNP per capita $765 or less; Middle income countries: GNP per capita between US$766 and US$3,035.

Source: Ibid.

China received an impressive 86% of the total FDI to low-income countries in 1995 (see Table 1). Beginning with its liberalisation in 1979, it received increasing FDI averaging US$2.5 bn per year between 1982 and 1991, thereafter accelerating by over 700% to US$ 37.5 bn in 1995. The amounts reported are gross overestimates, however, arising from the phenomenon of `round tripping', whereby domestic money is funnelled out of the country and back in again to take advantage of tax breaks for foreign investors. A 1997 World Bank study pointed to a 37% overestimation of total flows in 1994 plus a further 12% as a result of the overvaluation of capital equipment contributed to joint ventures by foreign investors. Most of the foreign investment (68% in 1995) has been directed to the industrial sector, with 20% in real estate.

Nigeria is the second largest FDI recipient. Traditionally FDI has been concentrated in the extractive industries, but there has been a recent diversification into the manufacturing sector, which had 47% of FDI stock in 1992.

India recently emerged as the third largest recipient. Incentives initiated in 1991 and subsequent more `open door' policies have brought a cumulative FDI flow of US$ 2.9 bn during 1991-5, compared with a total of US$ 1.0 bn during the previous two decades, most of it is going into infrastructure, particularly power and telecommunications, and petroleum refining, petrochemicals and automobiles in the manufacturing sector.

Of the six other main low-income recipients (see Table 1), the most promising is **Vietnam** which, despite its much smaller economy, has already been compared to China in terms of FDI potential. FDI legislation introduced only in 1987-8 facilitated an increase in inflows from US$ 8 m in 1988 to US$ 25 m in 1993. A further 300% increase followed after the lifting of US economic sanctions in early 1994. Most of this investment has been channelled into the petroleum and gas industries. **Bangladesh** received little FDI until the 1991 reforms, which allowed the establishment of 100% foreign-owned subsidiaries without prior permission. This led to an impressive increase in FDI from US$ 11 m in 1994 to US$ 125 m in 1995. According to the most recent statistics, the manufacturing sector (mainly textiles and clothing) accounted for almost one-fifth of investment inflows approved in 1992. Other important industries are food processing, electric machinery and chemicals. Finally, **Ghana**, where FDI was relatively low, averaging US$11.7 m during 1986-92, increased its inflows in 1993-5 by more than 17 times to an average of US$201 m. This was mainly as a result of the Ashanti Goldfields privatisation.

Table 1: Foreign Direct Investment - Main Low Income Countries Recipients DFI inflows (US$m)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
All developing countries	10,100	14,500	21,200	26,000	33,735	41,324	50,367	73,135	87,024	99,670
All low-income countries	2,549	3,802	4,675	7,229	4,682	7,229	13,846	31,619	38,410	43,405
China	1,875	2,314	3,194	3,393	3,487	4,366	11,156	27,515	33,787	37,500
Nigeria	167	603	377	1,882	598	712	897	1,345	1,959	1,340
India	118	212	91	252	162	141	151	273	620	1,750
Pakistan	105	129	186	210	244	257	335	354	422	639
Angola	114	119	131	200	-335	665	288	302	350	400
Sri Lanka	30	60	46	20	43	48	123	195	166	195
Ghana	4	5	5	15	15	20	23	125	233	245
Viet Nam	-	-	8	4	16	32	24	25	100	150
Bangladesh	2	3	2	-	3	1	4	14	11	125
Total of above countries	2,415	3,445	4,040	5,976	4,233	6,233	13,001	30,148	37,648	42,344
% of all low-income countries	94.7	90.6	86.4	85.2	90.4	86.3	93.9	95.3	98.0	97.6
of which China	73.6	60.9	68.3	48.4	74.5	60.4	80.6	87.0	88.0	86.4

of which the rest	21.2	29.7	18.1	36.8	15.9	26.0	13.3	8.3	10.1	11.2

Source*: UNCTAD, *World Investment Reports 1993-6

Determinants of FDI flows

The unpredictability of autonomous FDI flows, in both scale and direction, has generated a substantial research effort to identify their major determinants. An extensive literature based generally on three approaches - aggregate econometric analysis, survey appraisal of foreign investors' opinion, and econometric study at the industry level - has failed to arrive at a consensus. This can be partly attributed to the lack of reliable data, particularly at the sectoral level, and to the fact that most empirical work has analysed FDI determinants by pooling of countries that may be structurally diverse. The remainder of this paper is mainly concerned with examining the factors influencing the destination of the investment: host-country determinants, rather than industry-specific factors.

Size of the market

Econometric studies comparing a cross section of countries indicate a well-established correlation between FDI and the size of the market (proxied by the size of GDP) as well as some of its characteristics (for example, average income levels and growth rates). Some studies found GDP growth rate to be a significant explanatory variable, while GDP was not, probably indicating that where the current size of national income is very small, increments may have less relevance to FDI decisions than growth performance, as an indicator of market potential.

There is little doubt that the size of China's market explains, in large part, the massive FDI flows it has attracted since the early 1980s. Within China, FDI has been concentrated (over 90%) in the coastal areas. Provincial GNP, reflecting economic development and potential demand, has also been indicated as the major determinant of this concentration (Broadman and Sun, 1997)

For sub-Saharan Africa as a whole, Bhattacharya *et al.* 1996 identify GDP growth as a major factor. Only three SSA low-income countries are amongst the nine main recipients of FDI flows in recent years (see Table 1), and of these only Nigeria is close to being classified as a large market (according to UNCTAD's benchmark of $36bn GNP). Angola and Ghana (with GNP of $8.9bn and $5.5bn in 1995 respectively), received larger proportional FDI flows in 1995 than Nigeria (see Table 2), indicating that small market size need not be a constraint in the case of resource-endowed, export-oriented economies. In fact, extractive industries in the low-income African countries continue to attract foreign investors as they have always done.

In contrast, India, Pakistan and, to a certain extent, Bangladesh, have large markets but received proportionately relatively small (below 1%) FDI flows in 1986 95. Some analysts interpret this as evidence of high potential for increased FDI flows in the future; others stress that constraints are still restraining the channelling of foreign investment to these countries.

For the majority of low-income countries which fail to attract large FDI flows, their small domestic markets are often cited as the main deterrent. Given other economic and political shortcomings, most investors are doubtful about the value of installing a factory unless they can achieve a `critical mass' for their products. Regional integration is often perceived as a positive means of compensating for small national markets. There is currently no clear evidence of the degree of this influence on FDI flows. Some investors expect positive spillover effects from South Africa and are generally optimistic about an East African free trade area, but the benefits may well be concentrated in the economically stronger states.

Openness

Whilst access to specific markets - judged by their size and growth - is important, domestic market factors are predictably much less relevant in export-oriented foreign firms. A range of surveys suggests a widespread perception that `open' economies encourage more foreign investment. One indicator of openness is the relative size of the export sector. Singh and Jun's 1995 study indicates that exports, particularly manufacturing exports, are a significant determinant of FDI flows and that tests show that there is strong evidence that exports precede FDI flows. China, in particular, has attracted much foreign investment into the export sector. In Bangladesh, on the other hand, foreign investors have been attracted to the manufacturing sector by its lack of quota for textiles and clothing exports to the European Union and US markets. Garment exports, for example, rose from virtually nil in the 1970s to over one-half of its export earnings by the early 1990s. In contrast, most low-income SSA economies have remained more inward-oriented.

Labour costs and productivity

Empirical research has also found relative labour costs to be statistically significant, particularly for foreign investment in labour-intensive industries and for export-oriented subsidiaries. The decision to invest in China, for example, has been heavily influenced by the prevailing low wage rate. The rapid growth in FDI to Vietnam has also been attributed primarily to the availability of low-cost labour. In India, in contrast, labour market rigidities and relatively high wages in the formal sector have been reported as deterring any significant inflows into the export sector in particular.

However, when the cost of labour is relatively insignificant (when wage rates vary little from country to country), the skills of the labour force are expected to have an impact on decisions about FDI location. Productivity levels in sub-Saharan Africa are generally lower than in low-income Asian countries, and attempts to redress the skill shortage by importing foreign workers have usually been frustrated by restrictions and delays in obtaining work permits. The lack of engineers and technical staff in these countries is reported as holding back potential foreign investment, especially in manufacturing; it lessens the attractiveness of investing in productive sectors.

Political Risk

The ranking of political risk among FDI determinants remains somewhat unclear. Where the host country possesses abundant natural resources, no further incentive may be required, as is seen in politically unstable countries such as Nigeria and

Angola, where high returns in the extractive industries seem to compensate for political instability. In general, so long as the foreign company is confident of being able to operate profitably without undue risk to its capital and personnel, it will continue to invest. Large mining companies, for example, overcome some of the political risks by investing in their own infrastructure maintenance and their own security forces. Moreover, these companies are limited neither by small local markets nor by exchange-rate risks since they tend to sell almost exclusively on the international market at hard currency prices.

Specific proxy variables (e.g. number of strikes and riots, work days lost, etc.) have proved significant in some studies; but these quantitative estimates can capture only some aspects of the qualitative nature of political risk. Surveys carried out in South Asia and sub-Saharan Africa appear to indicate that political instability, expressed in terms of crime level, riots, labour disputes and corruption, is an important factor restraining substantial foreign investment.

Infrastructure

Infrastructure covers many dimensions, ranging from roads, ports, railways and telecommunication systems to institutional development (e.g. accounting, legal services, etc.). Studies in China reveal the extent of transport facilities and the proximity to major ports as having a significant positive effect on the location of FDI within the country. Poor infrastructure can be seen, however, as both an obstacle and an opportunity for foreign investment. For the majority of low-income countries, it is often cited as one of the major constraints. But foreign investors also point to the potential for attracting significant FDI if host governments permit more substantial foreign participation in the infrastructure sector. Recent evidence seems to indicate that, although telecommunications and airlines have attracted FDI flows (e.g. to India and Pakistan), other more basic infrastructure such as road-building remains unattractive, reflecting both the low returns and high political risks of such investments.

Surveys in sub-Saharan Africa indicate that poor accounting standards, inadequate disclosure and weak enforcement of legal obligations have damaged the credibility of financial institutions to the extent of deterring foreign investors. Bad roads, delays in shipments of goods at ports and unreliable means of communication have added to these disincentives.

Incentives and operating conditions

Most of the empirical evidence supports the notion that specific incentives such as lower taxes have no major impact on FDI, particularly when they are seen as compensation for continuing comparative disadvantages. On the other hand, removing restrictions and providing good business operating conditions are generally believed to have a positive effect. In China, the `open-door' policy and enhanced incentives for investing in the special economic zones contributed to the initial influx of FDI. Further incentives, such as the granting of equal treatment to foreign investors in relation to local counterparts and the opening up of new markets (e.g. air transport, retailing, banking), have been reported as important factors in encouraging FDI flows in recent years.

The Indian Government has recently relaxed most of the regulations regarding foreign investment. This is seen as contributing to the increased FDI flows in the last couple of years. However, the lack of transparency in investment approval procedures and an extensive bureaucratic system are still deterring foreign investors; hence the relatively low FDI/GNP ratios. In 1991, Bangladesh and Pakistan implemented reforms allowing foreign investors to operate with 100% foreign ownership but still failed to attract significant flows (as a proportion of GNP) because of political instability and an over-extended bureaucracy. Nigeria, in contrast, continues to attract foreign investment as an oil-exporting country despite its erratic and relatively inhospitable policies. With regard to the remaining low-income countries with small FDI inflows, surveys indicate that the lack of a clear-cut policy with respect to foreign investment and excessive delays in approval procedures are amongst the most important deterrents. Although a number of African countries set up `one-stop investment shops' during the 1980s in order to simplify approval procedures, the increased workload created bottlenecks.

Privatisation

Though privatisation has attracted some foreign investment flows in recent years (e.g. Nigeria in 1993 and Ghana in 1995), progress is still slow in the majority of low-income countries, partly because the divestment of state assets is a highly political issue. In India, for example, organised labour has fiercely resisted privatisation or other moves which threaten existing jobs and workers' rights. At a regional level, 1994 figures show 15% of FDI flows to Latin America as derived from privatisation, but only 8.8% in sub-Saharan Africa and 1.1% in South Asia. A number of structural problems are constraining the process of privatisation. Financial markets in most low-income countries are slow to become competitive; they are characterised by inefficiencies, lack of depth and transparency and the absence of regulatory procedures. They continue to be dominated by government activity and are often protected from competition. Existing stock markets are thin and illiquid and securitised debt is virtually non-existent. An under-developed financial sector of this type inhibits privatisation and discourages foreign investors.

Conclusions

Over the last 25 years, FDI in low-income countries has been highly concentrated in three countries, China, Nigeria and India. Large market size, low labour costs and high returns in natural resources are amongst the major determinants in the decision to invest in these countries. New major destinations for FDI flows in the 1990s include Vietnam, Ghana and Bangladesh. Given the easier access to their markets, motives for investment in these economies are mainly determined by the low cost of labour and the availability of natural resources.

For the vast majority of low-income countries, however, FDI is minimal. The structural weaknesses of these economies, the inefficiencies of their small markets, their skill shortages and weak technological capabilities, are all characteristics that depress the prospective profitability of investment. These factors also make it less worthwhile for potential international investors to incur the costs of a serious examination of local investment opportunities, thus leading to informational inefficiencies. The financing requirements of economic growth in these countries are therefore unlikely to be fulfilled by private capital inflows. Until these constraints on possible investment are addressed, they are likely to continue to rely heavily on receipt of foreign aid.

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