

# private sector

## FDI Trends

### Looking Beyond the Current Gloom in Developing Countries

**The fall in foreign direct investment (FDI) since 1999, and China's growing share, worry most developing countries. But an in-depth look reveals new and promising trends. The decline is largely a one-time adjustment following the privatization boom of the 1990s. FDI is coming from more countries—and going to more sectors. The conditions for attracting FDI vary by sector: in labor-intensive manufacturing, for example, efficient customs and flexible labor markets are key, while in retail access to land and equal enforcement of tax rules matter most. Sorting out the microeconomic issues by sector will be good not only for FDI but also for domestic investors.**

The flows of foreign direct investment (FDI) to developing countries have declined by 26 percent since 1999, while China's share has increased from 21 percent to 39 percent (figure 1). The large flows of FDI to banks and utilities dwindled following a series of disappointments for both investors and governments. China now has a commanding lead in manufacturing, with a large, qualified, low-cost, and flexible workforce. India seems to be following suit in the promising offshore services sector.

As a result of all this, many developing countries regard their prospects for FDI as bleak. The gloom is particularly strong among Latin American and Southeast Asian countries, once the darlings of foreign investors. FDI levels in Africa, the Middle East, and South Asia have

remained low. Eastern European countries are counting on integration with the European Union to help renew FDI flows.

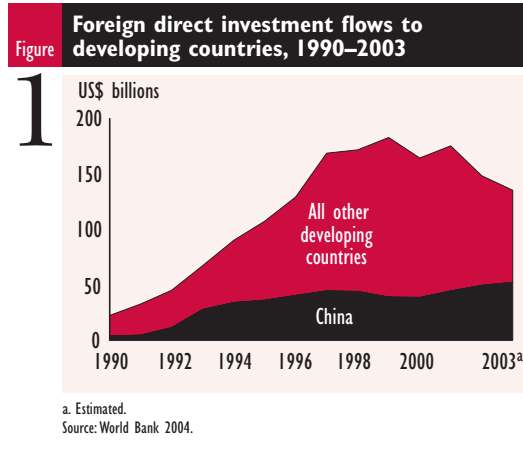
#### Reasons for hope

But a more in-depth look suggests a more complex and hopeful story. Despite the decline in FDI since 1999, its growth over the past 13 years has been phenomenal, averaging more than 17 percent annually in dollar terms. The decline since 1999 is due mostly to the drop in FDI following the boom in huge (one-time) privatization deals in the infrastructure, financial, and petroleum sectors in the 1990s. FDI in other sectors remained fairly constant (figure 2). This cyclical effect is confirmed by the much starker "rise and fall" pattern in FDI flows to industrial

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countries over the same period. Another (hopefully one-time) factor driving the decline has been the macroeconomic crisis and uncertainties affecting Latin America.

**Positive impact on development**

While many observers believe that much of the FDI in the financial and infrastructure sectors yielded little impact, this perception does not stand up to in-depth analyses such as those by Luis Guasch (2002), Clive Harris (2003), and the McKinsey Global Institute (2003). These studies have shown that in almost all cases FDI had a largely positive impact on productivity (the key criterion for assessing long-term economic performance) and on the coverage of services. But ill-designed privatization processes, contracts, and regulations have often led to poor returns on investments or, in some cases,

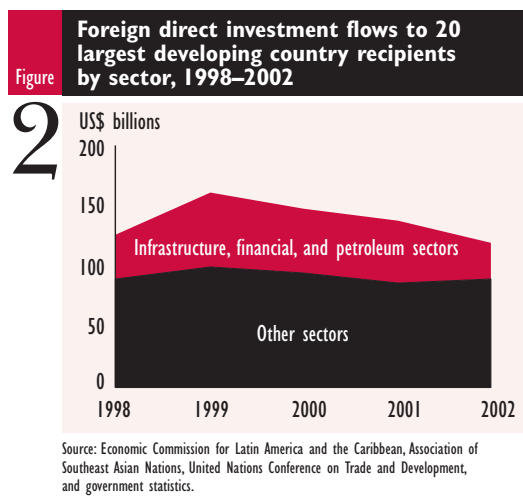
to excessive returns. The financial and infrastructure sectors are tricky to regulate as quasi-natural monopolies, but FDI is not to blame for government shortcomings.

In sectors where competition is stronger, FDI has had a much more obvious positive impact. A study of India by the McKinsey Global Institute (2001) showed that the removal of FDI restrictions in the automotive sector unleashed competition and investments, resulting in a threefold increase in productivity that translated into a threefold increase in output due to falling prices (figure 3). Employment also rose.

So, once adjusted for the one-time events and government shortcomings, the fundamental picture of FDI is quite positive.

**China in perspective**

China’s commanding FDI performance also should be put into perspective. While China accounts for 39 percent of the FDI to developing countries, it also accounts for almost 30 percent of the developing world’s population. In fact, relative to GDP, China’s performance in attracting FDI is good but not extraordinary, with FDI at 3.8 percent of GDP in 1999–2002. Nineteen developing countries did better over the same period. China’s performance looks even less extraordinary if adjusted for the round-tripping of FDI through Hong Kong (China), which some estimates suggest may account for as much as 30 percent of total FDI to China.

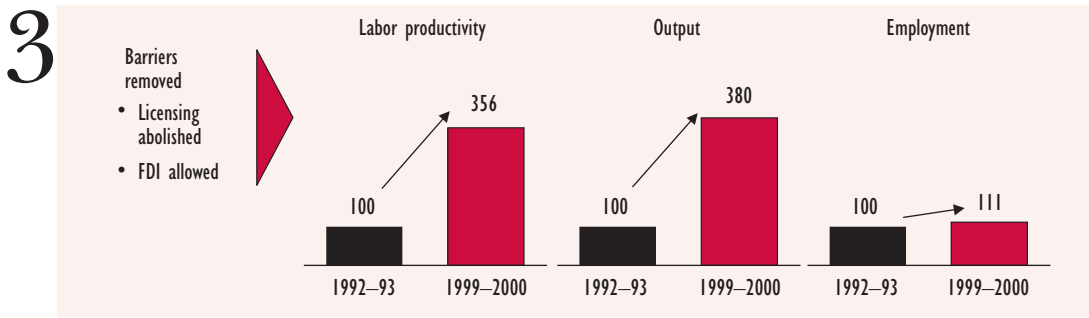


**New diversity in sources and destinations**

Another reason for hope is that the sources of FDI are increasingly varied. “South-south” FDI flows are expanding rapidly; they now account for more than 30 percent of FDI to developing countries, up from 17 percent in 1995. China and South Africa are becoming major players in Africa, for example, with about US\$2.7 billion and US\$1.6 billion of FDI there by 2001, the latest year for which statistics are available.

That developing countries are growing sources of FDI is doubly good news because these new players tend to be better equipped to invest in difficult and remote markets and to develop products and services better adapted to

**Figure** Impact of foreign direct investment in the Indian automotive industry  
Index: 1992–93 = 100



Source: McKinsey Global Institute 2001.

developing country consumers. The Turkish conglomerate Koc was the first company to open hypermarkets in the Russian Federation—with great success. Chinese electronics producers such as TCL know how to produce US\$50 color televisions in India and Vietnam, while Maruti Suzuki in India is ready to export cars for US\$2,000. These are low-spec products, but they are exactly what consumers in developing countries need, as they often face the unhappy choice between high-spec but unaffordable “Western” products and very low-spec but relatively expensive traditional products.

Yet another reason to be hopeful is that the destination sectors of FDI also are becoming more varied. FDI has evolved from focusing primarily on natural resources, infrastructure, and manufacturing (export-driven or “tariff jumping” investment) to also covering banking, retail, construction, tourism, and offshore services. Cumulative FDI flows to the retail trade sector in the 20 largest developing countries amounted to US\$45 billion in 1998–2002 (about 7 percent of the total to these countries). That too is good news, since more and more countries can hope to develop comparative advantages in a few of these new sectors. Moreover, FDI is increasingly market seeking rather than efficiency seeking (that is, export driven), offering opportunities to any country willing to open its markets or integrate with its neighbors.

These encouraging FDI trends in the developing world should be expected to continue, since they mirror what has happened in the industrial world.

### Implications for governments

So there is no reason for developing countries to despair. But in an increasingly competitive market, getting their fair share of FDI flows and benefits will be hard work. Attracting FDI will require a shift in mind-set for most developing country governments.

### Broadening the scope of FDI

To start with, the scope of efforts to attract FDI must encompass all economic sectors. The tendency in the past was to focus almost exclusively on infrastructure and on efficiency-seeking and tariff-jumping FDI in manufacturing. In the future more and more FDI will be market-seeking investment in service sectors as well as investment in tourism and offshore services. Most developing countries continue to restrict FDI in service sectors (for example, India does not allow FDI in retail), yet are ready to waste fortunes to attract efficiency-seeking FDI for manufacturing in an uphill battle against China.

There is a general misconception that market-seeking FDI in domestic sectors such as retail yields little development impact. The opposite is true. FDI in retail has been a key driver of productivity growth in Brazil, Poland, and Thailand, resulting in lower prices and higher consumption. Large-scale foreign retailers are also forcing wholesalers and food processors to improve. And they are now becoming important sources of exports: Tesco in Thailand and Wal-Mart in Brazil are increasingly turning to local products to feed their global supply chains. Retail also happens to be a pillar of the

tourism industry. The misconceptions about FDI are made worse by political economy factors: while attracting efficiency-seeking FDI does not affect incumbents, attracting market-seeking FDI usually does.

### Tackling microeconomic issues

In addition to broadening the scope of efforts, countries must recognize that the battle for FDI will increasingly be fought at the microeconomic level sector by sector. Of course, foreign investors will continue to insist on basic political and macroeconomic stability, but this should become less important as a differentiating factor. Investors will look increasingly at microeconomic conditions, and what they look for will vary significantly from one sector to another.

The requirements for efficiency-seeking investment in manufacturing are increasingly well understood—low factor costs, a flexible labor market, a small regulatory burden, efficient infrastructure and customs. Less obvious factors include easy access to a competitive supplier base and business service providers.

The factors required to attract FDI in domestic services are vastly different—a stable and smart regulatory environment for quasi-natural monopolies (a hard-won lesson from the 1990s), functioning land markets for retail, hotels, and construction. In addition, unfair competition from tax-evading, low-productivity informal players has been found to be among the biggest constraints to FDI growth in domestic services in most developing countries, and it tends to get worse over time.<sup>1</sup>

Resolving the microeconomic issues sector by sector will be good for FDI as well as for domestic private investors—and thus key to boosting growth and reducing poverty. But most developing countries have a long way to go.

### Note

1. The importance of microeconomic barriers to growth has been documented in great detail by the World Bank's Investment Climate Assessments (<http://www.worldbank.org/privatesector/ic/index.htm>) and Doing Business studies ([http://rru.worldbank.org/Doing\\_Business/](http://rru.worldbank.org/Doing_Business/)) as well as by the McKinsey Global Institute's industry-level analysis (<http://www.mckinsey.com/knowledge/mgi/>).

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