Globalization, FDI and Growth: A Regional and Country Perspective

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"The celebration of capital flows in the early 1990s and the subsequent skepticism were both excessive. The reality is more complicated and therefore requires a more nuanced policy response… This implies a multiplicity of measures that not only foster absorption of international capital flows but also generate long term domestic benefits."
World Bank, Global Development Finance 2001

I. Introduction

Globalization is recognized, by its supporters and detractors alike, as a major trend of the last two decades, not unlike a snowball that gathers strength as it rolls, carrying with it most bystanders. But the agreement ends here: although globalization has strong support in the developed and developing countries, as well as throughout the economics profession, it has equally strong opposition among its detractors or "discontents"[1]. Why such contrary views? Can the benefits of globalization be proven in such unequivocal manner that its opponents can be converted? Are the opponents completely irrational and impervious to empirical arguments and proof?

There is little doubt that some of the opponents are not interested in listening to theoretical or empirical arguments, but there is also a growing concern among more balanced observers of the process, that all is not good in the globalization process, that its impacts vary among regions and countries, and that even within countries benefiting from the process, there may be sectors and groups for whom the costs may well be greater than the benefits. A growing "respectable" literature on the subject is developing, and the empirical evidence from different countries is gradually being sifted to learn the lessons from the process so far.

This paper will focus on these arguments only as they apply to one of the components of globalization, i.e., foreign direct investment (FDI)[2]. While the paper touches briefly on the theoretical arguments, its main focus is an exploration of the very

1 J. Stiglitz, "Globalization and Its Discontents", W.W. Norton & Co., June 2002.

2 Foreign direct investment (FDI) is defined as investment that is made to acquire a lasting management interest (usually 10 percent of voting stock) in an enterprise operating in a country other than that of the investor (defined according to residency), the investor's purpose being an effective voice in the management of the enterprise. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments (World Bank, "Global Development Finance 2002", hereafter, GDF2002). This tedious definition is relevant for the discussion that follows, as the concept of FDI in many discussions often refers to only some of its components.

different experiences among regions and countries, particularly as FDI grew and evolved, adopting different shapes in the increasingly integrated world environment of the 1980s and 1990s.

A major conclusion of the paper is that, in the case of the arguments about FDI, as in so many other arguments, both sides are partially or mostly right, but are often discussing different processes. In other words, they are "ships passing each other in the night". Specifically, many of the arguments emphasizing the benefits of FDI are implicitly based on the assumption that most, if not all, of the FDI consists of "greenfield" investments in the manufacturing sector flowing to countries with a good policy and institutional environment. On the other hand, many critics are (often also implicitly) discussing other types of FDI, ranging from oil and mineral extraction to privatization of utilities, other mergers and acquisitions (M&A), as well as investments in the financial sectors and other forms of FDI, frequently under monopolistic or oligopolistic market structures.

The paper also concludes that the rapid expansion of FDI in the last decade, and the different composition of FDI among regions require a more region- and country-specific analysis of its impacts: when this is done, many of the apparent "counterfactuals" disappear, while the policy prescriptions for "maximizing benefits, minimizing costs"[3] of FDI become more robust.

In addition, economic theory also suggests that some of the predicated economic benefits of FDI (e.g. an increase in the recipient country's total investment) would decline as capital market integration increased, and the experience of the 1990s is indeed one of major market integration[4]. Thus, in the review of the impact of FDI on different countries and regions, both the differences among categories of FDI, and among country conditions (including the domestic regulatory environment for FDI but also market structures , and degree of external capital market liberalization) need to be considered.

II. Globalization and its Components.

Globalization is often defined as a combination of four major trends, including the expansion of international trade, financial flows (with FDI as the most important component of these flows), global communications (including transport) and movements of people (immigration). The same four factors have been present in the so-called "first wave of globalization" of 1870-1914[5], as they were in the post World War II period

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[3] See, for example, OECD, "Foreign Direct Investment for Development. Maximizing Benefits, Minimising Costs" 2002.

[4] The World Bank's "Global Development Finance 2001" (hereafter GDF 2001) notes that Martin Feldstein had already established in his 1994 NBER paper that, "As a matter of theory, the impact of foreign capital on domestic investment is ambiguous" GDF 2001, page 60.

[5] Historians would remind us that an even greater wave was present from the end of the XV century on, with the arrival of Europeans to the Western Hemisphere, and previous similar experiences had happened,

through the 1970s and in the most recent wave, starting in the 1980s and consolidating in the decade of the 1990s.

The causes and determinants of the globalization waves, their impact on the countries affected by them, and in the countries left in the margins of the process, have been studied from different perspectives, but the interactions among the different components have often been neglected. For example, in the exploding literature[6] about the ongoing trends, most of the attention has been devoted to the international trade part of the process, and to the links between increased trade and growth, with countries being defined as "globalizers" depending on their share of world trade[7].

But the four major trends in the globalization process have worked differently among different countries: financial flows, and particularly FDI show a different regional and country pattern from that of international trade: some "globalizing" countries in the study referred above have increased their share of trade with little FDI (e.g. India) while others received much higher FDI (e.g. China). Also, some countries have received high levels of FDI in the 1990s as a share of GDP and shown little or no economic growth (e.g. Angola, Ecuador).

Trade flows. From the trade perspective, the progress in developing countries has been substantial: the share of trade (sum of imports and exports) in GDP for all developing countries increased from 34.6 percent in 1990 to 51.6 percent in 2000[8]. This is considerably above both the level of trade, and its growth, in the developed countries during the same period (their share of trade in GDP increased from 32 percent to 37.1 percent).

The increasing importance of trade for developing countries affected low and middle income countries in similar ways, although the share of trade in low income countries remained below that for middle income countries: the former increased from 26.7 percent to 41.3 percent and the latter from 36.6 to 53.5. It is worth noting that even for the least developed countries as a whole, the share of trade in GDP exceeds that of the developed countries.

Foreign Direct Investment. FDI going to developing countries has also increased substantially during the 1990s but, contrary to trade, it remains at levels well below those of industrialized countries (3.5 percent of their GDP in 2000, against about 10 percent for the developed countries).

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through the centuries, in the Mediterranean and in the Arabic Sea (with expanding trade posts along the East African coast. In all cases, technological improvements in transport (communications) were cause and effect of the process, and increased trade and financial flows, and immigration were part of it.

[6] The references here are solely to the literature on the economic aspects of globalization, not to the political, sociological and cultural aspects, which is equally exploding.

[7] For example, in the World Bank's "Globalization, Growth and poverty: Building an Inclusive World Economy", 2002

[8] The source for all statistical data is the World Bank's "World Development Indicators 2002" unless otherwise indicated.

The different categories of FDI are commonly grouped under two main headings: greenfield investments to build new capacity, and the acquisition of assets of existing local firms[9], commonly referred to as "mergers and acquisitions" (M&A).

The latter also include several very different types of transactions, such as acquisition of private domestic companies by foreign investors, and privatization of state-owned enterprises, when the buyers are foreign investors. From a sector perspective, foreign investment has been substantial, at different times and different regions, in manufacturing, oil extraction and mineral mining, trade (including banking) as well as public utilities (mostly power—through Independent Power Producers or IPPs—and telecommunications, but also water and roads).

Such different transactions are generated by different country conditions and opportunities, and have different impacts on the host country. Thus a detailed look at the components of FDI flows will be required when focusing on specific regions and countries. At this point, however, we will look at the overall trends, noting also some of the global structural changes within FDI.

III. Trends in Financial Flows

Private Capital Flows.

Total financial flows to developing countries grew much faster than trade throughout the 1990s: they increased more than five-fold (from $ 43.5 billion in 1990 to $ 225.8 billion in 2000). The latter figure is still below the all-time highs of 1997 and 1998 ($ 268 billion in 1998), but shows that the effects of the 1997-98 East Asia crisis and subsequent contagion to Latin America and the Russian Federation were relatively moderate and by no means cancelled the tremendous growth of the early 1990s. Low-income countries, however, received a small fraction of the above amounts and a smaller amount at the end of the decade: the total flows *decreased* from $ 6.6 billion in 1990 to $ 4.5 billion in 2000.[10] This makes the increase to middle income countries even more spectacular: from $ 35.9 billion to $ 221.3 billion or a more than six-fold increase.[11]

[9] GDF 2001, Box 2.3, notes that FDI statistics are compiled from balance of payments data and include both types, but do not distinguish among them. Thus, M&A data are compiled separately, from individual transaction reports, and the greenfield component is estimated by difference. But the balance of payments data is on a net basis and includes other components: reinvested earnings, subtraction of disinvestments and repatriated profits, etc. .

[10] The low-income group figures for 2000 include substantial positive and negative amounts for individual countries. For example, the total net inflow for India was $ 8.8 billion, whereas Indonesia had a net *outflow* in excess of $ 11 billion. Thus the importance of looking closer at the country-by-country picture later in this paper.

[11] It should be noted that China started the decade in the low-income country group, but ended it in the middle-income group. The comparisons above, however, are for the same group of countries in the two years; i.e., China is included in the middle-income group for 1990.

Are regional differences substantial? All regions in the developing world experienced an increase in total capital flows throughout the decade (Table 1 below). But the regional distribution shows that three of the six regions (Latin America, East Asia and Eastern Europe account for the biggest share of the flows (92 percent of the total) as well as the largest increases during the decade. Among the other three regions, Africa also achieved a large increase, although from a very low base, as did South Asia, whereas the Middle East and North of Africa remain at the lowest level and with the lowest increase.

Table 1
Net Capital Inflows by Region, 1990 and 2000

Net Inflows ($ billion)	East Asia	Eastern Europe and Central Asia	Latin America	Middle East and N. Africa	South Asia	Sub-Saharan Africa	Total
1990	19.4	7.7	12.6	0,4	2.2	1.3	43.5
2000	65.7	45.4	97.3	1.1	9.3	7.1	225.8

Major Trends in FDI

Increasing amounts. Foreign direct investment is the largest component of total capital flows, and its share has become larger over time. It increased from $ 24.1 billion in 1990 (55.4 percent of total net flows), to $ 166.7 billion in 2000, or nearly 74 percent of total flows. Most importantly, foreign direct investment grew continually during the 1990s, including the East Asia crisis and until 1999, when it reached $185.4 billion. Thus, the first decline in more than a decade took place in 2000, suggesting that the slowing of growth in OECD countries had a bigger impact on FDI than the earlier difficulties in developing ones[12].

FDI increased faster in middle-income countries: in 1990, FDI to low-income countries was $ 2.2 billion or about ten percent of that going to middle income countries, while in the year 2000 it had increased to $ 6.6 billion or about four percent of the FDI to middle income countries. Overall, however, FDI became an increasingly more important, and more reliable, source of capital for all the developing countries as a group and for the low- and middle income sub-groups separately.

Regional concentration. There were also significant differences among regions (Table 2 below). First, there was a substantial decrease in the volume directed to the Middle East and North of Africa region between 1990 and 2000. At the other extreme, the increase in FDI to Eastern Europe and Central Asia is the largest, increasing more than twenty eight times from its level in 1990. The regional concentration, however, is very similar to that of total capital flows, with LAC, EAP and ECA accounting for 93.4 percent of the total (and LAC alone for 45 percent).

[12] Preliminary data reported in GDF 2002 indicate a small increase again for 2001, to $ 168.2 billion.

Table 2
Foreign Direct Investment by Region, 1990 and 2000

FDI ($ billion)	East Asia	Eastern Europe and Central Asia	Latin America	Middle East and North of Africa	South Asia	Sub-Saharan Africa
1990	11.1	1.0	8.2	2.5	0.5	0.8
2000	52.1	28.5	75.1	1.2	3.1	6.7

There were also major differences in the volatility of FDI amounts going to different regions. Only ECA and Latin America show a constant growth trend (with a small decline for Latin America in 2000) while East Asia shows a decline in the late 1990s and a recovery over the last two years. South Asia, Middle East and North of Africa and Sub-Saharan Africa show much greater year-to-year volatility. Smaller amounts of FDI, and "lumpiness" of the investments account for this volatility. The Middle East and North of Africa Region has moved from the third highest recipient to the smallest in the past decade, falling way behind all other regions, while South Asia, in spite of its increase has fallen well behind the level received by Africa. Direct foreign investment was negative in only one developing country (Indonesia) in 2000, but in 1998 and 1999 there was negative foreign investment in some other countries.

Country concentration. The large increase in FDI is concentrated in a small number of countries: the twelve largest recipients of FDI in 2000 [13] accounted 85 percent of the total. This concentration is only partially related to country size, as the twelve largest recipients include large countries such as China and Brazil and Mexico, but also small ones such as Singapore and other relatively small economies such as the Czech Republic and Chile. At the same time, the list does not include the Russian Federation or India, large economies that receive considerable FDI but in smaller amounts than the above countries. In addition, the highest shares of FDI in GDP are not in the countries receiving the largest amounts: of the five largest recipients, only in Brazil does FDI exceed 5 percent of GDP, which is only one half of the share in developed countries, while the highest share among developing countries is in Angola, at nearly 40 percent of GDP. Chile, the Czech Republic, and Singapore, on the other hand show more of a "developed country" structure with FDI around 10-12 percent of GDP.

Changing Composition. The composition of FDI, between "greenfield" and M&A FDI, has changed considerably towards the later: for all developing countries, the share of M&A in foreign investment increased from 18 percent in 1995 to 36 percent in 1999[14]. Practically all of the M&A transactions have been in middle income countries, largely reflecting privatization transactions in Latin America and post-crisis asset sales in

[13] The twelve countries are China, Brazil, Mexico, Argentina, Korea, Poland, Singapore, Iran, the Czech Republic, Venezuela, Chile and Thailand.
[14] GDF 2001, page 41.

East Asia. The latter have raised the so-called "fire sale" debate as some observers argued that assets were sold to foreigners at prices below their long-term value, because sellers lacked liquidity and markets were thin (more on this later).

Finally, another change in the composition of FDI during the 1990s was the increase in investment in non-mining, non-manufacturing sectors. FDI in sectors such as trading, finance (banking and non-banking institutions), and infrastructure (power, water, and, to lesser extent, roads) increased substantially, both through privatizations and private M&A, but also through greenfield investments (e.g. in the power sector). Most of this activity was in the middle-income developing countries (Latin America, Eastern Europe and East Asia) but with some activity in Africa and South Asia (IPPs).

In spite of its rapid increase, FDI as a share of GDP is still much smaller in developing countries than in industrialized ones: for the latter, this share increased from 3.0 percent in 1990 to 10.1 in 2000; in the developing countries the share increased from 0.9 percent to 3.5 percent in the same period.

IV. FDI and Economic Performance: A Regional Overview

To better understand the regional and country patterns of FDI, and the reasons for these patterns, this section will look at each region's experience in attracting FDI, the links between FDI and performance, also at the region and country level, and the reasons for the differences. Table 3 below presents an overview of regional performance in FDI, GDP growth and trade: a major paradox is immediately evident in that the major destination for FDI, both in absolute amounts and in percentage of GDP (Latin America) has had much lower growth rates than other regions (East and South Asia), as well as much lower degree of "globalization" as measured by the share of trade in GDP.

Table 3
Regional Trends: FDI, Growth and Trade

Region	GDP Growth Rate (1990-2000)	FDI/GDP (2000)	Trade/GDP (2000)
East Asia	7.2	3.9	65.6
Latin America	3.3	4.5	37.7
Eastern Europe	-1.5	3.8	65.6
South Asia	5.6	0.6	24.3
Middle East and N. A.	3.0	1.0	51.6
Africa	2.5	1.8	56.8

Equally surprising is the performance of Eastern Europe, the third largest destination for FDI, again in absolute amounts and as a share of GDP: although it has a high share of trade, it has experienced a significant decline in growth during the decade.

South Asia, on the other hand, exhibits the second largest growth rate together with very low FDI and is the most "closed" region in terms of trade share.

Finally, only East Asia exhibits the expected combination of high growth, high openness to trade and high FDI (while Sub-Saharan Africa shows the—also expected—mirror image of low growth and low FDI, although with high trade shares). These findings are summarized in Table 4 below, where we would expect to find most regions in the NE and SW quadrants, while in reality, half regions are in the NW and SE ones. The rest of the section explores the reasons for the apparent paradoxes by looking at each region separately, at the differences among countries (including their resource endowment and policy environment) and also among the different types of FDI discussed above: the conclusion is that the links between FDI and growth depend on both, country characteristics, and the type of FDI. First, the section looks at the three regions with high levels of FDI, and then turns to the regions where FDI is low or decreasing.

Table 4
Regional Growth and FDI

FDI / GDP Growth	**Low**	**High**
High	Latin America Eastern Europe	East Asia
Low	Sub-Saharan Africa Middle East and N. of Africa	South Asia

Latin America. The largest recipients of FDI in Latin America are Brazil, Mexico and Argentina[15]. Only Chile appears in the list of the 12 major recipients and among the developing countries with the highest share of FDI/GDP (see Annex Tables I and II). The region has been the major recipient of FDI throughout the decade, and the increase has been constant except for minor hiccups in 1994, 1998 and 2000 (corresponding to the "tequila" crisis, the East Asia crisis and the OECD slowdown. But growth performance was moderate to poor, and the three major countries have suffered country-specific crises throughout the decade. What explains, then the large amounts of FDI? Undoubtedly, the three countries have received foreign investment for new (greenfield) companies but the

[15] GDF 2002 (Annex 4) notes that in 2001, Mexico surpassed Brazil as the second largest world recipient of FDI (behind China).

bulk of the FDI flows have been related to privatizations of infrastructure companies and other M&A activities. The magnitude of these transactions is sometimes large enough to cause substantial year-to-year variations and affect overall regional flows.

For example, in 2001, regional FDI fell slightly, to $ 71 billion (from $ 75 billion in 2000), but the small decrease hides much larger declines in Argentina and Brazil, partly compensated by an increase to $ 25 billion in Mexico[16]. But a *single transaction* in Mexico's financial sector (the sale of Banamex-Accival to Citigroup) accounted for half of the 2001 total![17]. For the region as a whole, M&A, from privatizations or private sector acquisitions have been well above the average for all developing countries. In 1998, for example, M&A accounted for more than $ 50 billion, from a total FDI of about $ 70 billion[18]

Some of the smaller countries in Latin America also have large FDI in terms of GDP, with shares similar to those of developed countries. In addition to Chile, countries with high shares include Guatemala and Nicaragua (just above 10 percent each), followed by Bolivia (nine percent), plus Jamaica and Panama with 7 percent. Privatizations also account for a large component of the FDI in these countries who also had moderate to low growth rates

The regional averages should not detract from the impressive performance of some Latin American countries, particularly Chile, with an annual average growth rate of 6.8 percent for the entire decade. The other fast-growing countries in Latin America were smaller countries receiving moderate or low FDI (Dominican Republic, Costa Rica, El Salvador, Peru). Thus, Chile remains as the Latin American "poster child" of the virtuous cycle of high FDI, high growth and trade openness.

East Asia. To what extent is East Asia a good example of the combination of high FDI, high growth and high trade? And, which way is the causality? To discuss these issues it is necessary to go beyond the averages for the region, noted above. In the first half of the 1990s, and through 1997, the growth of FDI in East Asia was widespread among many countries in the region, and the composition included greenfield projects as well as M&A investment from privatization and other operations. After 1998, however, the resilience of FDI in the region was the combination of continuing large increases in China, declines in others, as well as changing composition in other countries.

One important change was an increase in M&A activity (from its already substantial pre-crisis level) in Korea, Thailand, Indonesia and, to a lesser extent, Malaysia. The large increase in M&A that followed the crisis was dubbed by some a "fire sale FDI", because the sales prices were often at a fraction of the book values. Yet, it is clear that some countries, such as Korea, benefited substantially from these transactions,

[16] GDF 2002 2002, Annex 4, page 176.
[17] GDF 2002, Chapter 2, page 40.
[18] GDF 2001, Figure 2.7

which brought foreign exchange into the country and helped enterprises to recover. The M&A activity continued to later years.

In most East Asian countries, however, FDI did not recover from the 1997-98 crisis. This is particularly the case for Indonesia, where FDI has been *negative* for four years in a row (i.e., every year since 1998). Preliminary figures for 2001 indicate that the FDI outflow in Indonesia was about $ 6 billion or about the same as the increase in China between 2000 and 2001. In the other major countries of the region (Korea, Malaysia, Thailand, Philippines) FDI, although positive, has declined since the crisis and specially during the last two years. Yet, growth in these countries was strong in 2000 (although fell substantially in 2001).

The above suggests that the only "model" performance in the region is that of China, with continuing high growth, growing FDI and high trade openness (for a country its size). What is it then, that makes China special? At 4.5 percent of GDP, the level of FDI is similar to that of Argentina, for example, but as a share of investment it is considerably smaller; also the share of M&A is well below the Latin American amounts. But the most important difference seems to be in the origin of the FDI: the major source is Hong Kong and a good share of this seems to be "round-tripping" from Chinese investors who move money offshore and bring it back to China disguised as foreign investment[19] . The reason for this "round-tripping' is a combination of the incentives for FDI, as well as a concern that the government may impose exchange restrictions on residents. Round-tripping was estimated at nearly a quarter of all FDI in 1992 and may have increased in later years. Thus, a good share of FDI in China seems to be domestic investment.

Eastern Europe experienced the fastest growth in GDP throughout the 1990s, while its GDP actually fell. But a closer look at the year-by-year variations shows that most of the decline in GDP took place in the early years of the decade, while the increase in FDI took place later (and was largely linked to privatizations). As GDP growth resumed, in the late 1990s, FDI continued to increase through 2000[20], when four countries received FDI amounting to close to (or exceeding) 10 percent of their GDP. These countries were the Slovak Republic (with more than 12 percent), Estonia, Moldova and the Czech Republic (in Bulgaria and Kazakhstan, FDI was also high as a share of GDP).

If the regions receiving most of the FDI going to developing countries exhibit such different behaviors, impact on growth, and sources of FDI, how about the remaining three regions (Sub-Saharan Africa, South Asia and Middle East and North of Africa) where FDI remains small and, in one case decreasing? The following paragraphs review

[19] GDF 2002, Box 2.3. The FDI amounts from Hong Kong decreased somewhat after 1997, but were compensated by equivalent amounts from the Virgin Islands.

[20] In 2001, GDP growth fell, and FDI to most of the countries fell also, although increases in Turkey and Kazakhstan offset the decline in other countries and the total remained mostly unchanged (GDF 2002, Appendix 4.)

their recent experience and show that the differences among the three are at least as high, or even higher than the differences between, say East Asia and South Asia.

Sub-Saharan Africa's FDI increased during the early and mid-1990s, in parallel with GDP growth increases during the same years. But both GDP growth and FDI seem to have peaked around 1997; since then the growth rate has fallen and FDI has fallen also[21]. The regional share of 1.8 percent of GDP hides a wide range of different country experiences, reflecting the diversity of the continent. Country shares go from a high of nearly 40 percent of GDP in Angola and 14.5 percent in Gabon (both because of oil sector investments), to a considerable number of countries where foreign investment is absent or negligible. The divide between oil exporters (and other mineral producers) and oil importers in terms of FDI has remained substantial: the GDF 2002 reports that a full 60 percent of all FDI to the region in 2001 went to oil exporting countries.

At the country level, Mauritius with 6.4 percent of GDP continues its tradition of welcoming export-oriented industries and foreign investment (and sustaining GDP growth), while Uganda with 3.5 percent and Ghana and Tanzania with 2.1 percent show the results of successful economic reforms (all three countries had negligible FDI in 1990). Nigeria has kept its share at 2.9 percent, not much higher than ten years earlier, pulled in opposing directions by the attractiveness of its petroleum resources and the difficulties of a poor policy and institutional environment, and South Africa has experienced substantial progress but has a still low share of 1.2 percent of GDP. Policy reforms matter, in Africa as elsewhere, for FDI going to the mining sector also: in Mali, for example, policy reforms during the 1990s led to FDI and two new operating mines, and gold is now the major source of export earnings.

South Asia. If Latin America and Eastern Europe are the "high FDI, low growth" regions (with East Asia as the *high/high* case and Africa as the *low/low* one), South Asia presents the opposite oddity, with limited FDI and a robust growth performance. In spite of a substantial increase during the 1990s, FDI was still very low by 2000, both in absolute amounts and as a share of GDP[22]. Yet, growth performance during the decade was second only to East Asia, and well above Latin America.

Because India dominates the South Asia figures, it is useful to look at the different elements of India's performance: a growth rate of 6 percent per year throughout the 1990s was achieved with little FDI (0.6 percent of GDP in 2000, about $ 2.3 billion). Behind this remarkable growth performance was an opening of the economy through the reforms of the early 1990s. One of the most important reforms was a partial liberalization of trade and investment regulations, leading to a substantial increase in trade, from 13

[21] FDI in 2000 was about $ 7 billion. Preliminary figures for 2001 (in GDF 2002, Appendix 4) show a nearly doubling of FDI, to about $ 13.7 billion. GDF 2002 notes, however, that all of the increase was due to a single transaction in South Africa: "the purchase of De Beers by Anglo-American--which shifted ownership of assets from South Africa to London without generating substantial new investment" (GDF 2002, page 188)

[22] South Asia received $ 3.1 billion of FDI in 2000, or less than 2 percent of the total; the share of Gross FDI in regional GDP was 0.6 percent. Regional GDP growth during the decade was 5.6 percent per year.

percent of GDP in 1990 to 20 percent in 2000. These are still small trade shares, even for a large economy (China's trade share is more than twice that size, at 43.9), but it is the increase, perhaps more than the absolute amount that matters. Similarly, the increase in FDI looks much more impressive than the absolute level, as it increased by more than fourteen times between 1990 and 2000 (about twice as fast as total FDI to developing countries during the same period)[23].

FDI to India, Pakistan and Bangladesh is roughly proportional to the size of their economies. In Pakistan (and to some extent in Bangladesh), a substantial share of FDI in the 1990s was due to IPP investments. Some of these investments faced difficulties because the government-owned utilities were unable to meet their obligations under the long-term power purchase agreements (PPAs). Privatizations were also an important component of FDI in South Asia, but less so than in other regions, as the pace of privatization remained slow. Yet, domestic demand expansion, export growth and domestic investment (particularly in India) combined to generate substantial growth. FDI appears to have played a useful complementary role, although with trade and industrial deregulation, and macroeconomic policy improvements, domestic savings and investment did the heavy lifting.

The Middle East and Northern Africa. The Middle East and North of Africa region also has very low levels of FDI, and moderate to low growth[24]. The highest recipient of FDI (in absolute amounts) is Egypt[25]. The highest share in GDP is that of Tunisia, largely because of oil and gas resources but also due to a gradually improving business environment. Jordan and Yemen have been the other (relatively) popular FDI destinations in the region while Egypt has experienced a decline from the situation ten years earlier (1.7 percent of GDP in 1990 and only 1.3 in 2000). Morocco, an otherwise "globalizer" with a high and increasing share of trade in GDP also shows a very low share of FDI, increasing only from 0,6 percent of GDP in 1990 to 0.8 percent in 2000.

The regional FDI figures show substantial year-to-year variations within the overall low levels, and a concentration in oil-exporting countries. The second major source of FDI has been the privatization of some government-owned companies. At the country level, the highest shares of FDI in GDP are in Tunisia, Yemen and Jordan, which boast some of the highest growth rates in the region.

High-Growth Countries. To conclude this section, we look at the world's fastest growing developing countries and at their FDI levels and trend: a total of 33 developing countries achieved growth rates above 4.5 percent annually from 1990 to 2000. Of these, the top ten[26], all with growth rates above 6 percent p.a., include six countries that are seen

[23] FDI in India increased again in 2001, from $ 2.3 billion to $ 3.3 billion (GDF 2002, Appendix 4).

[24] The region received $ 1.2 billion of FDI in 2000, or less than 1 percent of the total; the share of Gross FDI in regional GDP was a low1 percent. Regional GDP grew by 3 percent per year during the last decade.

[25] In 2001 Saudi Arabia also received substantial FDI (about $ 1 billion), after three years without any positive inflows, due to the approval of limited foreign participation in hydrocarbon projects (GDF 2002, Appendix 4).

[26] China, Sudan, Vietnam, Singapore, Uganda, Malaysia, Chile, Myanmar, Lao PDR, and Mozambique.

as attractive destinations for FDI (China, Malaysia, Singapore, Chile) or where FDI is recently growing (Vietnam, Lao PDR, Uganda), but also countries that operate at the opposite end of the spectrum (Sudan, Myanmar). The next group of 11 countries, with growth rates between 5 percent and 6 percent p.a.[27] show a similar pattern, including countries with already substantial FDI (Korea, Mauritius), some with smaller but increasing FDI (India, Costa Rica) and less likely candidates for FDI (Syria, Lebanon). Finally the remaining 12 countries, with growth rates of 4.5 to 4.9 percent[28], include several countries with moderate but growing FDI (Bangladesh, Cambodia), but only one with substantial FDI (Poland).

The above shows, once again, that many, if not most, high GDP growth countries receive moderate to high (and increasing) FDI, but that substantial FDI amounts have gone to low growth countries. It also suggests that the relations between the two, and the effects of FDI on growth are complex, and that a typology of countries, and of types FDI flows, is needed to explain the findings. The next section in this paper attempts this typology and tries to summarize the different factors at play.

V. FDI and Growth: Reconciling Theory and Findings

The benefits of FDI, as of all other capital flows, to developing countries are expected to arise through two major mechanisms (i) by increasing total domestic investment, and (ii) by increasing productivity. Both effects are expected to result in higher growth rates. This section reviews how the regional and country experiences summarized above meet the expectations of these two links between FDI and growth.

FDI and Domestic Investment

M&A and greenfield transactions. What has been the impact of FDI on domestic investment? At the aggregate level, the "FDI elasticity of domestic investment" (i.e. the percentage increase in domestic investment associated with a given percentage increase in FDI) has been found to be positive, but decreasing over time, from nearly 2 in the 1970s and 1980s to about .75 in the 1990s[29].

The major reason for this decline has been the increase in the percentage of M&A transactions (including privatization) in total FDI, and the corresponding reduction in greenfield transactions. The latter imply immediate increases in productive capacity, whereas the first do not, although they may be accompanied by subsequent improvements in equipment and management. Some major privatizations in countries experiencing large fiscal deficits, the macroeconomic effect of the privatizations may have been a relaxation of the fiscal and balance of payments constraint and, thus, the maintenance of long-term macroeconomic disequilibria that are known to have a negative impact on growth (the

[27] India, Dominican R., Lebanon, Oman, Syria, Yemen, Korea, Costa Rica, Mauritius, Sri Lanka and Jordan.
[28] Nepal, Burkina Faso, Bangladesh, Cambodia, Benin, Botswana, El Salvador, Ethiopia, Peru, Tunisia, Egypt and Poland
[29] GDF 2001. Figure 3.3

privatizations, however, may also have achieved microeconomic improvements at the firm level, in some cases large enough to be noticeable at the macro level).

The regional discussion above showed that the share of M&A was highest in Latin America and Eastern Europe, thus helping to explain their "high FDI/low GDP growth" performance, and lower in East Asia (particularly before the 1997 crisis). On the other hand, FDI in Africa (and low income countries in general), although small, has had a larger direct impact on total investment, mainly because of the high share of greenfield transactions.

The "explosion" of FDI of the M&A type during the 1990s was the result of a number of factors that cannot be repeated over time: they include the disintegration of the Soviet Union and the subsequent major economic transformation (leading to privatization) in the economies of Eastern Europe and Central Asia, the major wave of privatizations in Latin America as a new, more market-friendly policy stance was adopted in most of the region, and the so called "fire-sales" in East Asia following the 1997 crisis. Although there is still ample room for further privatizations in all regions, and private-to-private M&A will continue, it is highly unlikely that the conditions of the 1990s will be repeated, and the composition of FDI (and, thus, its regional concentration) is bound to change in the coming years. This is already noticeable in the declining trends of 2000 and 2001, although major M&A activities have continued to lay a major role.

Indirect effects on investment. More generally, even when FDI results in the immediate increase of new productive capacity, it may be replacing domestic investment that would take place otherwise (and thus generating increased consumption or capital outflows)[30] as has been argued for several Latin American countries, particularly Argentina.

In other cases, one impact of FDI may have been to substitute for domestic investment and even to delay, at least temporarily the adoption of necessary policy reforms. The history of FDI in the power sector of several countries shows some of these contradictory forces at play. Independent power producers (IPPs) were set in many countries, to face urgent power shortages and the inability of existing public utilities to finance the necessary investments. To make these investments attractive, the host countries offered long-term purchasing power agreements or PPAs, as well as subsidized financing and other arrangements that in some countries were neither transparent nor competitive. To some extent, these new investments allowed countries to delay the necessary reforms in the power sector, including addressing the inefficiencies of the public utilities.

The IPP experiences of Indonesia and Pakistan have been amply reported, as many of these transactions face difficulties some years later: in the absence of policy

[30] The balance of payments impact of M&A is quite different from that of greenfield transactions: in the latter, the foreign exchange inflow is often fully or nearly fully compensated by an outflow due to imports of capital goods, in the former, the FDI does not generate a compensatory foreign exchange inflow, which is then available for other purposes (including consumption and capital outflows)

reforms in the sector, the public utilities were not able to purchase the electricity at the agreed prices, and there were also problems with the availability of foreign exchange to pay the IPPs. On the other hand, IPPs have been successful, and spurred further FDI, as well as economic growth in countries were transparency and competitiveness were properly taken into account, and where macroeconomic and sector policy conditions were satisfactory (several Latin American countries are examples of the positive results).

Sector composition. In addition to industry and utilities (power, water and even roads), FDI has been a major presence in the mining and financial sectors of many developing countries. FDI in each of these sectors has separate features and a different impact on domestic investment and growth.

In the mining sector (including oil) the bulk of the FDI has been for new productive capacity (although some major privatizations and other M&A have also been important[31]). Also, mining sector FDI has occurred in countries where little or no other FDI takes place. This includes Angola and Gabon (which, as noted earlier, have the highest FDI to GDP ratio in Africa) as well as Kazakhstan or Azerbaijan. The presence of significant FDI in the mining sector of low income countries has clearly resulted in an increase in overall investment (as well as output and export) in these countries, although the second transmission mechanism for the expected benefits of FDI (increases in productivity) have been elusive (see below).

FDI in the financial (mostly banking) sector has been dominated nearly exclusively by M&A transactions. In Eastern Europe, this took place through privatization of previously government-owned banks, and by 1999 more than 50 percent of the banking sector of Hungary, Poland and the Czech republic were under foreign control. In Latin America, the process was mainly through private-to-private M&A transactions (reaching 25 percent of the sector in 1999), and in East Asia it was through the purchase of banks in financial distress but reached only 6 percent of total assets in 1999[32]. Thus, the higher volume of banking FDI transactions in Latin America and Eastern Europe *vis a vis* East Asia is another factor that partly explains the different links between FDI and growth in these three regions. The banking FDI did not increase total domestic investment by any significant amount, and its expected beneficial impact on growth should be a delayed one, through productivity increases (see below).

FDI and Productivity.

The second benefit of FDI, productivity increases, is expected to take place irrespective of whether it takes place through new production facilities or through M&A and, it could even be argued that it should appear more consistently in the latter, as any

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[31] The large 2001 purchase of De Beers by Anglo-American, in South Africa, has been noted earlier. The long process leading to the privatization of Zambia's ZCCM in 2000, also with Anglo-American as the foreign partner, and the latter's subsequent decision, in early 2002, to withdraw from Zambia have been widely reported in the press.

[32] GDF 2001, Box 2.4

acquisition should be based on the assumption that the new owners and management expect to operate the company more efficiently than the previous one.

Country conditions, however, have been pointed out by many studies as a major factor in determining to what extent FDI creates productivity 'spillovers', not just by increasing the productivity of the companies where it takes place, but that of other companies and the economy as a whole. The conditions that have been found to facilitate this "spillover effect" include human capital (work force well educated and trained), efficient infrastructure, and a positive business climate (including items such as depth of the financial markets, political stability, and efficiency of government services). These conditions, often grouped under the heading of "absorptive capacity"[33] vary substantially across regions and among countries and are another factor in explaining the different observed relations between the level of FDI and growth.

Does FDI in different sectors have differential impacts on productivity? This is a difficult question to answer empirically, because the effects are difficult to separate from country conditions. For example, the experience of countries with oil and other mineral resources shows several examples where FDI operates in an *"enclave"* environment and generates little or no positive "spillover" effects. But it is also clear that countries rich in natural resources (particularly oil) often have levels of FDI that are higher than those of countries with similar policy and institutional environments, but without such natural resources. Thus, the lack of clear productivity benefits may be due to poor country conditions (low "absorptive capacity") rather than to the sector. As oil and mining FDI is an important component of FDI going to Africa, the low observed productivity benefits may partially counteract the beneficial "investment" effects of FDI in that region.

Productivity benefits of FDI are also likely to be more gradual and delayed in appearing as compared with the investment benefits. Thus, many of the expected benefits of the 1990s increase in FDI may still be in the making. This is particularly true in sectors such as banking, where the indirect benefits are well known in terms of the impact of a more efficient financial sector on all other sectors of the economy (and the same is true for infrastructure). Yet, a note of caution is due here: with a majority of the banking and infrastructure FDI transactions being of the M&A type, and many of them large enough to have a "macro" impact, the success or failure of such operations may have a global impact on the host countries. The success or failure of an individual enterprise is subject to many internal and external factors and such events may bias even countrywide results.

The above leads to another factor affecting the benefits of FDI (mainly in privatizations, but also in some new investments as the IPP cases mentioned above): FDI may take place in an environment that involves a privatization of the monopolistic power (at times together with corruption in the process), or be the beneficiary of specific measures that confer a non-competitive market structure. In other words, FDI, like any other investment may also take place as a result of an inefficient policy and/or institutional arrangements and, in such cases, no sustained benefits are to be expected.

[33] GDF 2001, page 62.

VI. Summary Findings and Concluding Remarks.

This review of FDI trends, distribution and links to regional and country performance found that

- FDI increased enormously during the 1990s in all regions except for the Middle East and North of Africa. The growth of FDI stopped, and in some cases declined after 1997.
- Latin America, East Asia and Eastern Europe are the regions receiving most of the FDI going to developing countries. Within these regions, concentration is high among a few countries
- South Asia, Sub-Saharan Africa and the Middle East and North of Africa receive low levels of FDI, in absolute terms and as a share of GDP
- The regions with high levels of FDI are not always the ones experiencing faster growth of GDP
- Only East Asia shows the expected association between high FDI and high growth. Similarly, Africa and to some extent the Middle East show the mirror image of low growth and low FDI
- Latin America and Eastern Europe had high FDI but low (or negative) growth, and
- South Asia experienced high GDP growth and growing FDI but still at a very low level in absolute terms and as a share of GDP

In exploring the reasons for these results, some of the major findings, relative to the different types of FDI and their impact on growth are that

- The "growth elasticity" of FDI has decreased over time
- The impact of FDI on growth is expected to arise from its impact on total investment and productivity
- FDI includes both new investment and mergers and acquisitions (M&A). The latter grew faster than the former during the 1990s
- FDI through M&A transactions has a lower impact on total domestic investment than establishment of new companies ("greenfield investments").
- FDI through M&A, including privatizations and private-to-private acquisitions, was much more important in Latin America and Eastern Europe than in the other regions (but was important also in East Asia after the crisis—"fire-sales")
- FDI through M&A was particularly important in the infrastructure and banking sectors. The latter was particularly important in Eastern Europe and Latin America, and
- FDI in the oil and mining sectors is often of the "greenfield" type and the main source of FDI in low income countries

On country conditions, the main findings are

- The impact of FDI through increased productivity is highly dependent on the country's "absorption capacity" (including human capital, infrastructure, business climate and political stability)
- Oil and mining FDI in low-income countries frequently operates in an "enclave" environment with lower productivity spillovers; this might reflect country conditions more than sector features.
- The investment impact of FDI is greater in low income countries than in middle income ones, partly because of their lower level of integration in the world economy, and
- Some FDI may take place *because* of the presence of policy distortion (e.g. monopolistic market structures)

The above suggests that FDI includes a large variety of transactions, very different from one another, and taking place in a variety of country conditions. Thus, it is not possible, nor is it desirable to lump all of them together, into a single category and seek a common set of effects. It is true, however, that most types of FDI will have beneficial effects when taking place in the right country conditions, meaning a good policy environment and good "absorption capacity". And the reverse is also true: a good policy and institutional environment and high growth are likely to generate growing FDI (and positive effects). Many East Asian countries as well as a handful of countries in other regions (Chile, Poland, Mauritius) are an example of this "virtuous cycle".

But there are two major caveats to the benefits of FDI for developing countries: one is that, even under the best circumstances, FDI has played only an important but complementary role: domestic savings and investment are still the major source of growth for developing countries. This is a reminder that FDI, although by far the largest component of private capital flows to developing countries, and also the most stable, is but a small share of the GDP of these countries: 3.5 percent in 2000, up from 0.9 percent in 1990. With gross capital formation in developing countries at about 23 percent of GDP, foreign investment remains a minor player.

With a much higher share of FDI (10 percent of GDP) in high-income countries, the limiting factor is clearly not the supply of funds, even under the slower growth conditions at the beginning of the current decade. Historians would remind us also that the shares of FDI were much higher in earlier globalization periods, such as the one from 1870 to 1914. Should conditions (the "absorption capacity") in developing countries and aggregate demand in developed countries improve, FDI flows at the end of the current decade could show further increases to the ones between 1990 and 2000.

The second caveat is that FDI is clearly not a panacea for growth: there are several country instances of fast growth with little FDI and many more of substantial FDI with little or no growth. The discussion of country conditions, shows that, under certain conditions, countries can attract FDI for the wrong reasons (e.g. privatizing monopolistic power, delaying reforms, providing restricted access to markets or resources, etc.). Like any other investment, FDI can, on occasion, provide a private benefit at a public cost.

Annex Tables

Table I
Major Recipients of FDI in 2000 (in $ billion)

Country	FDI 1990 ($ billion)	FDI2000 ($ billion)	GDP Growth, 1990-2000	FDI/GDP 2000	Trade/GDP 1990	Trade/GDP 2000
China	3.5	38.4	10.3	4.3	32.5	43.9
Brazil	1.0	32.8	2.9	6.0	11.6	19.1
Mexico	2.6	13.3	3.1	2.3	32.1	60.8
Argentina	1.8	11.7	4.3	4.5	11.6	18.1
Korea	0.8	9.3	5.7	3.2	53.4	72.8
Poland	0.1	9.3	4.6	6.6	43.9	51.1
Singapore	5.6	6.4	7.8	11.6	309.9	295.3
Czech R.	0.2	4.6	0.9	9.3	84.0	120.5
Venezuela	0.5	4.5	1.6	4.0	51.1	39.7
Chile	0.6	3.7	6.8	12.0	52.9	51.4
Thailand	2.4	3.4	4.2	2.8	66.1	107.2
Russian Fed.	0	2.7	-4.8	2.4	16.5	60.0

Table II
Major recipients of FDI in 2000 (as a share of GDP)

Country	FDI/GDP 2000	FDI/GDP 1990	GDP Growth 1990-2000	FDI 2000 ($ billion)	Trade/GDP 1990	Trade/GDP 2000
Angola	39.9	3.3	1.3	1.7	53.5	127.5
Gabon	14.5	8.4	2.8	0.2	52.5	88.8
Lesotho	12.9	2.7	4.1	0.1	118.8	100.1
Slovak R.	12.2	..	2.1	2.1	110.8	128.5
Chile	12.0	2.2	6.8	3.8	52.9	51.4
Trinidad & T.	11.9	3.1	3.0	0.7	65.9	107.4
Singapore	11.6	20.7	7.8	6.4	309.9	295.3
Nicaragua	10.6	0.0	3.5	0.3	95.9	100.9
Estonia	10.2	2.0	0.5	0.4	..	149.5
Guatemala	10.1	0.6	4.1	0.2	36.8	39.1
Czech R.	9,3	..	0.9	4.6	84.0	120.5
Moldova	9.9	..	*-9.7*	0.1	..	96.8