Newsletter

December 2010
№16

Law Office Getsadze & Pateishvili LLC
5/II Pekini ave, flat 2, 0171 Tbilisi, Georgia
Phone/Fax: +995 32 21 33 63, +995 32 21 33 73; Website: www.g-p.ge, E-mail: office@g-p.ge

Determinants of FDI in Developing Countries

Review of Empirical Literature

Abstract: The below working paper presents significance of Foreign Direct Investment as the most important capital flow. Determinants of FDI appeared to be momentous in quantity and quality of flow of investment to certain host country. Many players changed their positions in this field and determinants respectively been classified. Their importance in the past might become vague depending on market demand, thus less important Determinants of FDI will come up on stage.

Role of Multinational enterprises in FDI stream directions as well as its quantity and sector related are important and still actual.

The contribution of below the paper is to evaluate determinants of FDI coming into force with Globalization and what should be kept in mind from the perspective of state policy to attract them in developing countries

Law Office Getsadze & Pateishvili LLC
5/II Pekini ave, flat 2, 0171 Tbilisi, Georgia
Phone/Fax: +995 32 21 33 63, +995 32 21 33 73; Website: www.g-p.ge, E-mail: office@g-p.ge

Nowadays almost every research or article covering topics of economics is starting with the indentation containing word “Globalization”. Everybody or every part of society has its own definition of this word and my aim is not defining it suitably. I would like find determinants of Direct Foreign Investments in Developing countries and Globalization was the first I think which gave the hint to FDI to start “action”.
The growth of international business activity in past century together with Foreign Direct Investments was the result of dramatically increased Globalization.

What is FDI, simple capital flow from one country (home) to another (host)? What are the main agendas of FDI home countries? Which countries were major players in this play?
In 50s and 60s of past century two Anglo-Saxon “Orb” - United Kingdom and United States were biggest exporters of FDI. When other countries like Japan and Germany had joined them, the competition for investments in transmarine countries grew.
Drawing paper with economic touch and not to mention Adam Smith or other fathers of economics might be a sin but one of the first who touched determinants of FDI was Bertil Gotthard Ohlin. The famous Swedish economist who stated that growing market with its high profitability was reason of FDI’s motivation to finance investments to host country at low interest rates.

Differentiation of Determinants

Foreign Direct Investment boom caused by internationalized or more correctly globalized marketing and production, which led to further involvements of developing countries into FDI, blossomed in 90s of XX century. Main role there played Multinational enterprises (MNE) which were deeply interested to locate the investments in competitive areas. The activity growth of MNE in the form of FDI had increased more rapidly than any other international transactions. Apart from FDI, Multinational enterprises had controlled big part of above mentioned international transactions[1].
What was the primary determinant of FDI, so the reasons of providing service to the foreign market with the help of affiliate production and not direct export? Existence of advantages in FDI host countries, mainly developing countries.

- imperfect competition - product discrimination
- economies of scale(internal or external)
- skill advantages - access to proprietary knowledge

1 John H. Dunning; 1999 Globalization and the Theory of MNE Activity 242 – 264 pp

- Restriction on imports – government policy

Researchers state that each company has its intangible assets, public goods: Now-How, Technology, Managerial qualities. So you can utilize with the same success those public goods in two different countries. The companies with variety of such assets tended to have multiple manufactures[2].

I would like to get back here to John Dunning whose works about MNEs link directly to ownership of above mentioned assets. He evolved passage between Ownership, Location, and Internalization (OLI). The author's statement that OLI is one of main determinant of FDI and especially in developing countries, being agreed and argued at the same time. Arguments were as fallows that determinants varied whether FDI host countries were physically large or small, what was the stage of industrialization together with linked technology; Whether market was monopolistic or competitive; The nature of firm itself was important as well: was it big or small, products were innovative or imitated and etc.

In certain sector FDI home country firms have advantages of privileged ownership having intangible or tangible assets. The home country company decides ownership of these assets will be sold or internalized. The advantages of choosing location of FDI are also on the same side of the river (FDI Home country)[3].

Searching material whether ownership advantages were determinants of FDI, I have found out criticism of neoclassical explanation of FDI streams. First - Stephen Hymer and later in 1969 Charles Poor "Charlie" Kindleberger disputed that "usurpation" of perfect competition by neoclassical theory could give clear explanation of FDI. They argued that FDI's thrived with market imperfections. MNEs entering foreign market needed ownership advantage: managerial skills, market differentiation together with product, existing internal and external economies of scale, patent and etc. Having further disadvantages of entering new market with higher risks, cultural differences and ethics of doing business, physical distance and differences in legislature, existence of bureaucracy, FDI competed with local companies. In competition, state policy played significant role as well.

With years the rules of FDI game had changed respectively. Let's say Tariff-jumping FDI which allows firm (foreign) to escape from trade barrier with the help of locating production within market of destination. Probability of tariff-jumping FDI with trade barrier together with volumes and its effect on welfare relies on fallowing factors: Different entry, demand conditions, distinctive production costs and relocating costs. I have mentioned Changes and some companies had faced them, when governments act "strategically" – liberalising import regime in developing countries. With successive rounds of multilateral trade liberalization the relevance

---

2 Alan Rugman; 1980 Internalization as a General Theory of Foreign Direct Investment; 365 – 379 pp

3 John H. Dunning; 1988 Multinationals, Technology and Competitiveness; 1996 The role of FDI in a globalizing economy 43–66 pp.

of market access through FDI for many products had been declined[4].

Innovation as one of determinants of FDI was pointed out by Raymond Vernon in 1966. Innovation being labour saver is prerogative of countries with capital intensive features (US). As developing countries are labour intensive, production is moving there respectively. Thus capital intensive countries are redirected to the innovative products and services. Professor Vernon's model supposed to be "source" for trade representatives and subsidiaries in foreign countries[5].

There are another approaches relying on innovation as main profit maker. Technology being implicit is not transferred free of charge and companies evolve knowledge and volumes in transcendent ways. Using their knowledge they innovate in different countries with different environments increases advantages. Thus and so we get that here competition between firms is technological[6].

The economic growth stimulates FDI inflow. But being very important for economic growths there are strong differences between FDI inflows: whether both, Home and host countries are developing countries, or only host country is presenting by developing country. Latter is vertically efficient searching new markets for their investments while first is horizontally efficient as FDI is utilized in mergers and acquisitions and is interested more in strategic investments.

Some researchers show that FDI has very limited influence on economy growth and was influenced by trade . openness, the size of the market, low cost of the labour, economy clusters, low restrictions or barriers for FDI and ample natural resources.

Some developing countries carried out reforms which would have been helpful and attractive for FDI inflows. Investment climate which became amicable in developing countries looked into the foreign exchange control, the trade barriers and portion of government (state) participation in business.

Nevertheless this package of reforms is not enough. The infrastructure and its quality of FDI host country together with tax rates is of significant importance and this significance is bigger in developing countries. Tax rate sensitivity of FDI decreases with the increase of infrastructure and host country will not lose FDI inflow in case of tax increase if infrastructure is above average.

Together with above mentioned, the political will, existence of the quality of economic and institutional structures are momentous in the process of FDI attractiveness[7].

Corruption's role in FDI inflows or outflows should not be omitted but according to several studies two contro-

---

4 UNCTAD 1998; Foreign direct investment to Central and Eastern Europe - World Investment Report highlights trends in the transition economies

5 Raymond Vernon 1966; International investment and international trade in the product cycle, MIT Press

6 John Cantwell 2000; Capitalism, profits and innovation in the new techno-economic paradigm

7 Schneider, Friedrich & Frey, Bruno, 1985; Economic and political determinants of foreign direct investmen

versial attitudes were drained. The process of giving or taking bribes itself makes people to think about its negative impact even on sectors, or topics not related to their activity. Simply it is costly for everybody (who is giving bribes). Even not knowing the impact, they express their strong protest. On the other hand corruption in the presence of government weakness lubricates commerce. The negative attitude towards corruption somehow overcame by expenditure effects in long run and General equilibrium wage[8].

Different types of FDIs

There are determinants which vary in respect of different types of FDI. Thus they (determinants) become wither more important or less significant on certain case. For example FDI which are: market-seeking, resource-seeking, efficiency-seeking and strategic-asset-seeking.

John Dunning asserted that above mentioned FDIs simply varied in investment nature: The resource-seeking FDI hunting the natural, physical and human resources and market-seeking FDI trying to get domestic, regional and adjacent markets were general initial investments. Whereas efficiency-seeking FDI interested in "the rationalization of production to deed economies of specialization and scope across or along value chains", let's say product specialization appeared to be typical sequential investment. The strategic-asset-seeking FDI, link to creating of foreign assets: technology, managerial skills, organizational potential and market was sequential investment as well[9].

There are different studies and data which gave us specific factories into three groups, depending on type of FDIs. IN this particular case the source United Nations Conference on Trade and Development does not specify determinants for strategic-asset-seeking FDI.

Economical Determinants

Resource-seeking FDI	Market-seeking FDI	Efficiency-seeking FD
Raw Materials	Market Size	Labour cost for productivity adjustmen
Physical Infrastructure	Market Growth	Skilled Labour
Factors(complimentary) of production(labour)	Regional Integration	Trade Policy
		Services related to Business

8 Glass, Amy & Saggi, Kamal 2000; Exporting vc Direct Investment under Local Sourcing

9 John H. Dunning 1996; The Impact of the internal market on foreign direct investment

Host Country Determinants of FDI	
Overall Policy Framework	1. Stability (Economic / Political) 2. MNEs. Rules for entry and operations 3. FDI bilateral and multilateral agreement 4. Privatization policy
Business Facilitation	1. Administrative procedures (customs clearance, Tax Policy) 2. Infrastructure 3. FDI promotion (facilitation services) 4. FDI incentives (subsidies)

Source: UNCTAD (1998: Table IV ff)

There are some aspects from given table which we did not touch and will try to debate below. Privatization Privatisation is responsible for contribution into flows of FDI to developing countries:

1. The growth of FDI's share in services (industry)
2. The growing importance of mergers and acquisitions (opposed to Greenfield investment)

Note: Mergers and acquisitions in this certain sector, in contrast to Greenfield investment, are no more than ownership change.

FDI Bilateral and Multilateral agreements

"Because of similarities in interests and often more common values, bilateral trade agreements can go into new areas such as investment, competition, labour standards or environment, where there is no consensus among WTO Members". The definition of Mr. Lamy is acceptable at some point but there are opponents that doubt whether investment holders and receivers are inspired with the same will. At the same time he states that preferential agreements which are not based on bilateral interests are short-term and will conclude in a brief period of time. According to Mr. Lamy in the past bilateral trade agreements appeared to be useful for negotiators, especially for developing countries (to learn how to negotiate and become comfortable with the difficult terminology of trade)[10].

A negotiation on Multilateral Agreement on Investment (MAI) was hot topic during several years in Ministerial Conferences of the WTO. By the end of the XX century the lack of enthusiasm towards MAI could cause serious problem to the international trading system together with capital markets. However demand for FDI was accepted even by the extreme sceptics. Their fears towards FDI+MAI were somehow justified, as the split of the camps: developed vc less developed countries went too far.

As we mentioned several times FDI has been growing dramatically with the hint given by globalization, thus

10 Pascal Lamy, 2006 "Multilateral and bilateral trade agreements: friends or foes?" Gabriel Silver Memorial Lectur

capital flew to different countries all over the world. Nevertheless FDI increase appeared to be unbalanced, as some Developed countries together with Less Developed Countries benefited more than others.

Conclusion

With the FDI boom and interest from developed countries in past century, developing countries had learnt how to attract investments. There might be the point that FDI is some kind of zero-sum play in the game of trade. The determinants of FDI are different thus we get various effects on FDI attractiveness. In addition the determinants of FDI, which were sufficient in the past, may appear less relevant in the future. While importance of openness, Tax Policy, Quality of infrastructure, defeated bureaucracy and other determinants will remain the significant for the further flows of FDI.

According to different researches traditional market-related determinants are still dominant factors which are shaping the distribution of FDI.

Teo Tsotsolashvili

Economic Development Expert at Getsadze & Pateishvili Law Office