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Shaping Globalization

New Trends in Foreign Direct Investment

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Introduction

Helmut Hauschild

Cross-border investment was a driver of global economic integration long before the term globalization emerged as a synonym for the international division of labor. For centuries, people engaged in commercial activity have invested abroad to take advantage of lower-cost resources, to establish cheaper production facilities and to open up new markets.

However, the extreme speed at which the global division of labor has accelerated within the past decade is unprecedented. The global map of cross-border investment flows has changed dramatically both in size and in direction. Regions with low economic activity labeled until recently the "Third World" have become important destinations for and, increasingly, origins of investment. In 2011, the amount of foreign direct investment (FDI) directed towards developing and emerging countries reached for the first time a level above that received by established industrial nations (UNCTAD 2012). Against the backdrop of high debt, sluggish growth and decreasing populations observed in Europe, Japan and the United States, the new economic powerhouses in Asia and Latin America are most likely to continue their rise.

China and Hong Kong are the clear frontrunners among this group of young investment destinations. With a combined inflow of $207 billion of FDI in 2011, they are drawing ever closer to the United States ($227 billion), the decades-long category leader. Other emerging economies are following suit. For instance, Brazil received $66.7 billion in 2011 after receiving $48.5 billion in 2010, clearly surpassing Great Britain, France and Germany. FDI inflows to India increased by 30% from 2010, totaling $31.6 billion in 2011.

The changes underway clearly demonstrate that the world economy's center of gravity is shifting. Economists agree almost unanimously: Asia is expected to serve as the most significant source of growth for the coming decades, followed by Latin America. A large and young population, combined with a

fast-growing middle class eager for consumer goods and services comprise the main drivers of these emerging markets. Investors from the saturated industrial countries are shifting their money into these regions to participate in this boom.

But it is not only as destinations for investments that developing and emerging economies are gaining in importance. Increasingly, they are taking on the role of investors themselves. In 2011, developing and emerging countries invested a combined $457 billion abroad, which is equivalent to roughly one-third of the outward FDI of advanced economies. Among the list of top source countries of FDI outflows, Hong Kong and China occupied fifth and ninth place, while Russia occupied sixth place (UNCTAD 2012).

After decades during which the industrialized countries of the North drove globalization, the South has become a driving force itself. A growing share of investment from emerging markets is flowing to other emerging and developing countries. This so-called South-South investment has increased by 20% per year since 1996, UNCTAD reports.

The emergence of new actors and the changes in the direction of investment flows have revived the debate over the benefits and risks of FDI. This book addresses some of the discussion's central topics, examining them from the point of view of recognized experts. It makes no claim to be comprehensive; rather, it deliberately selects aspects that play a significant role in the public's awareness.

In his introductory contribution, **Peter Nunnenkamp** provides an overview of the scholarly research on the positive and negative consequences of FDI inflows and outflows. Nunnenkamp indicates that the numerous studies on the topic have come to very different conclusions. Notably the debate on whether foreign investment in developing countries in fact stimulates economic growth in these countries still remains highly contentious. Nunnenkamp points out, however, that recent findings relating to emerging markets at a comparatively high level of development are much clearer. These countries are evidently more successful in turning the influx of foreign capital and know-how into growth than are poorer countries. The findings have important consequences for regions such as Southeast Asia where huge

inequalities in GDP per capita exist. They suggest that the disparities between rich and poor countries may continue to grow.

The same effect, if only temporarily, holds for the gap between affluent and poor sections of the population within a developing country. Empirical studies on the effects of FDI inflows on income distribution in developing countries show a limited impact on poverty reduction, Nunnenkamp notes. Whereas the well-educated segments of the workforce may benefit by receiving higher wages, the broader mass of workers gain little. In this sense, FDI at least temporarily exacerbates income inequality in poor countries. It is only in the long term, once the general level of education increases, that FDI inflows improve the income of a broader swath of the population.

Helmut Reisen and **Jan Rieländer** focus in more detail on the impact of FDI in Africa, juxtaposing advocates' assertions of economic benefits and critics' allegations of a "sellout" of Africa's natural resources against the findings of recent research. The authors note that Africa's share of global FDI inflows has risen sharply in the last decade, with a growing share originating in emerging economies, particularly China, India, Korea, Brazil and Turkey. However, this surge has recently levelled somewhat out and Africa's FDI stocks remain low in absolute terms. Evidence of positive growth effects has been mixed. The continent's largest share of FDI inflows have been directed towards resource-extraction industries, which have little spillover effect in terms of long-term positive growth trends. Yet Reisen and Rieländer note that even this type of investment can have a positive impact on growth by enabling capital accumulation within capital-poor economies. But long-term growth associated with FDI is seen primarily within countries where human capital, financial markets and infrastructure show comparatively high levels of development. Thus, efforts to raise human capital and technological capacities, provide a good business climate, and develop local infrastructure and financial sectors are crucial in enabling countries to reap the maximum level of benefits from FDI.

Reisen and Rieländer argue that emerging markets such as China, by providing comparatively low-cost infrastructure financing, have enabled African countries to make beneficial development gains; indeed, Chinese investment is correlated with positive developments even in "soft" infrastructure fields such as the rule of law and corruption control. In the

future, the authors note, increasing integration between African countries so as to provide a larger potential market could make the continent a more attractive destination for overseas investors.

Focusing on China as a relatively new source of significant FDI outflows, **Ting Xu** and **Yi Liu** examine China's increasing global importance as an investor and the mixed response notably in Western target countries to the growing number of Chinese takeovers. In Europe and the United States, where FDI originating from emerging economies is not yet the norm, public opinion oscillates between encouragement and concern.

On the one hand, investments made by the international community's newly wealthy – above all China with an estimated foreign exchange reserve of around three trillion U.S. dollars – are expected to help ailing companies survive the recession caused by the financial crisis. On the other, Chinese investors in particular are regularly suspected of harboring ulterior motives. State-owned Chinese companies and the China Investment Corporation (CIC), a sovereign wealth fund, have repeatedly been accused of investing in companies of strategic technological importance in order to gain access to security-relevant know-how or to infiltrate Chinese influence in politically sensitive areas.

To date, however, there is no clear evidence of any such strategy. Nonetheless, Xu and Liu note that Chinese investments do from time to time meet with political resistance, especially in the United States. This has led to incidents such as the multiple failed attempts by Chinese telecommunications equipment company Huawei to take over U.S. competitors.

In his contribution, **Joachim Pohl** addresses allegations of rising levels of protectionism in FDI. He identifies three primary motives behind recent moves by governments to prevent takeovers of local companies. First, national security or the desire to protect privatized infrastructure deemed critical in some way – particularly given the rise of sovereign wealth funds as sources of FDI – has been a strong source of protectionist impulses. This motive affects more than intended takeovers by Chinese investors alone. Even within the European Union, takeovers of companies deemed strategically important can be a source of conflict between member states and in some cases lead to intra EU acquisitions effectively being blocked. A prominent example of this is the

failed acquisition of Spanish energy company Endesa by German competitor Eon.

Second, responses to the economic and financial crisis blurred lines between emergency bailouts and protectionism. While G-20 members committed themselves to continued liberal policies, many states did provide significant support to domestic businesses, potentially discriminating against foreign competitors. Third, tension related to shifts in the international balance of economic power – particularly the rise of China – has led to calls for retaliation against perceived market abuses overseas.

In examining the recent record, Pohl concludes that evidence of actual protectionist action is relatively slim despite isolated examples in all three categories. However, protectionist sentiment remains strong due to the critical outlook for the world economy, he observes. Thus the dangers of such a path should not be ignored.

For aging societies with a shrinking workforce such as Germany, foreign investment in fast-growing young economies can be a means of securing high returns on savings. **Melanie Lührmann** and **Joachim Winter** therefore focus on the long-term effects of demographic change on global capital flows and the rate of return to capital.

Starting with a look at studies based on closed-economy general equilibrium models, Lührmann and Winter note that an increasing ratio of retirees to working-age individuals is predicted to lead to a state of "asset meltdown," in which a relative abundance of capital, decreases in national savings rates and capital market outflows trigger a decline in the rate of return to capital. Pension reforms focused on defined contributions and private saving exacerbate this effect within closed-economy simulations.

However, when looking at simulations of economies that encompass the flow of capital across borders, the decline in the rate of return to capital is reduced within the fastest-aging societies, and the amplifying effects of pension reforms disappear. By the same token, capital mobility implies that slower-aging societies, such as the United States, will see larger capital inflows than they would otherwise have experienced, essentially "importing" the effects of demographic transition from faster-aging nations. The authors

conclude that capital mobility does appear to reduce the danger of asset meltdown as societies age.

The global financial crisis has mainly hit financial markets in the advanced economies, prompting a massive shift of financial investment into emerging economies. Such capital inflows can be risky, as they may trigger excessive foreign borrowing, initiate asset bubbles and undermine economic competitiveness, among other things. These risks have revived the debate about possible cases in which capital controls should be introduced, writes **Jonathan Ostry** in his contribution. He examines the surges of capital that flooded into emerging economies as the global financial and economic crisis developed, and asks which mix of policies is best suited for minimizing disruption in these host economies. The answer is of high political relevance. Because as a consequence of massive capital inflows in the aftermath of the financial turmoil, a number of emerging economies have in fact introduced capital controls, most notably Brazil.

Ostry argues that in certain cases capital controls might be acceptable as a last resort, thus disapproving the credo of most economists for decades, that capital controls always do more harm than good. In seeking to curb unwanted inflows of capital, Ostry notes that fiscal and monetary policy, currency appreciation and foreign exchange market operations, as well as domestic prudential regulations are all potentially useful tools and should be given priority. He concludes, however, that, if these approaches have already been exhausted, or if an economy's macroeconomic condition does not allow their use, capital controls might be justified. This holds particularly if the alternative is allowing risky forms of foreign borrowing to destabilize the economy. Because the imposition of such controls does contain the risk of spillover effects if other countries retaliate or follow suit, any such action would be best governed by a multilateral framework, the author says. Moreover, measures should be continually reevaluated to ensure that benefits outweigh the costs.

Daniel Firger analyzes the role that foreign direct investment can play in international efforts to combat climate change through so-called low-carbon FDI. The most developed channels for such investment to date are the various markets for carbon credits, which in the wake of the Kyoto climate treaty have enabled investment serving an emissions-reduction purpose to earn credit against home-market emissions allotments. Uncertainty over the

post-2012 regime has hampered the development of these markets, however. Bilateral investment treaties that deal with climate issues, such as those between China and the United States or China and India, have emerged as a partial means of addressing uncertainty within the global regime. Firger notes that international investment agreements can be productively constructed or rewritten so as to protect governments' ability to impose climate-friendly regulation or to incentivize low-carbon FDI, though he notes that this trend remains in its infancy.

It is evident from all the contributions that foreign investment will continue to change the patterns of globalization. The identities and objectives of investors are becoming more diverse. The responsibility of governments to minimize financial fragilities will increase. Challenges like demographic change and global warming may emerge as new drivers of foreign investment that carries the potential to reshape globalization once again.

This transformation will be jarring – and to some extent even painful – for many in the world. Some economic actors – societies, governments, investors – may be tempted to turn inward or to act defensively in seeking to preserve elements of an already receding status quo. But as the contributions in this book argue, an open and cooperative approach to cross-border investment is best suited to harness the energy of the world's shifting balance of economic power and to ensure that a maximum number of people benefit from the opportunities transformation will provide.

Foreign Direct Investment in a Globalized World: It Works; It Doesn't; It Can, But That Depends…

Peter Nunnenkamp[1]

Changing perceptions and open questions

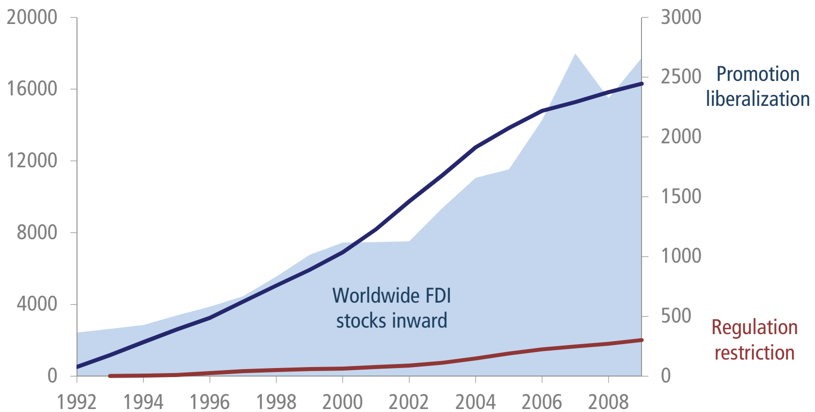
The public perception of foreign direct investment (FDI) appears to be flip-flopping between opposite extremes. Multinational enterprises as the drivers of FDI were "widely denounced as big, irresponsible, monopolistic monsters" in the 1970s (Economist 2000). Two decades later, the mood was upbeat in praising the same enterprises "as the bringers of foreign capital, technology and know-how" (ibid). Hostility returned when globalization critics blamed all-encroaching multinationals for crowding out local business and undermining government autonomy. Some critics have switched sides recently, and institutions such as the United Nations, which not long ago passed negative judgments on multinational enterprises, now expect these enterprises to help the fight against worldwide poverty (UN 2003).

Stiglitz (2000: 1076) calls for restrictions on other types of international capital flows, but finds the case for FDI compelling: "Such investment brings with it not only resources, but technology, access to markets, and (hopefully) valuable training, an improvement in human capital." This argument by a prominent skeptic resembles claims by the proponents of globalization. For instance, the OECD (2002) reckons that FDI promotes productivity and income growth more strongly than does domestic investment. Hence, it is hardly surprising that policymakers around the world have paid heed and entered into the global competition for FDI by relaxing previous restrictions

[1] The subtitle of this paper is borrowed from McGillivray et al.'s (2006) survey on the effectiveness of development aid. I would like to thank Mark McGillivray for his kind permission to use this subtitle.

and offering incentives such as tax exemptions. UNCTAD has recorded almost 2,500 measures taken by host countries to liberalize and promote FDI inflows since the 1990s, compared to just 300 measures to restrict and regulate FDI (Figure 1).

Figure 1: Worldwide FDI stocks inward (billion $, left scale) and national measures to promote and regulate FDI (number of measures, right scale), 1992–2009



Source: UNCTAD online database

Certainly, the more liberal policy environment has helped the global boom in FDI. Total (inward) FDI stocks soared from $2.1 trillion in 1990 to $17.7 trillion in 2009 (Figure 1). It is less clear, however, what role FDI has played in enhancing the economic clout of developing countries. Nor is it wholly apparent how effective liberalization and deregulation measures have been in luring FDI to particular locations. FDI remains concentrated in relatively advanced economies (see "How global is FDI?").

Furthermore, it is debatable whether host countries will necessarily benefit from FDI inflows. The currently prevailing wisdom takes favorable growth effects almost for granted, while widening wage and income gaps within the host economies are regarded as the price to be paid for FDI-induced increases in average incomes. Nevertheless, the debate on both counts is far from

resolved (see "Host-country effects" and "Inward FDI and income inequality"). Possible trade-offs between higher growth and rising inequality may depend on whether FDI takes place in technologically advanced or less advanced host countries. In the final section ("Repercussions of outward FDI") we address similar trade-offs with regard to FDI *out*flows. We conclude that the effects of FDI are theoretically and empirically ambiguous in almost all dimensions. The current euphoria about FDI may thus prove to be short-lived once again.

How global is FDI?

Several experts have spotted a "distinct shift in the pattern of FDI" (Kekic 2009). Kekic speculates that "practice may be catching up to theory," according to which FDI should flow from rich countries in which capital is abundant to poorer countries in which capital is scarce. UNCTAD reports that 2010 was the first year in which rich developed countries received less than half of global FDI inflows (Economist 2011). It is open to question, however, whether this really marks a lasting shift away from the traditionally preferred locations. Measured by less volatile stock data, FDI continues to be concentrated in the small group of developed countries. This group hosted 70% of worldwide FDI stocks in 2009, just five percentage points less than 20 years before (see also Figure 2).

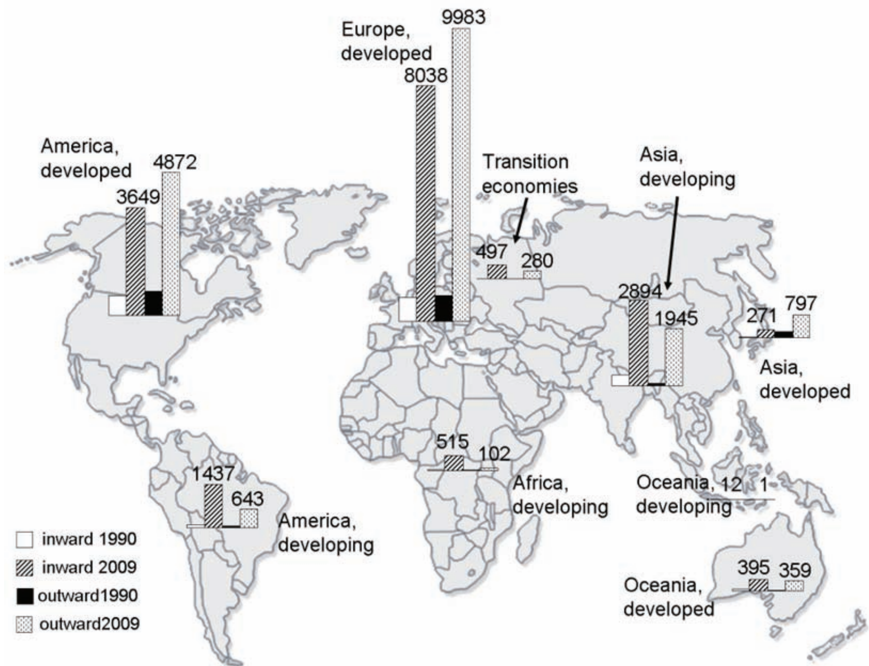
The distribution of FDI is also heavily skewed among developing and transition economies. Multinational enterprises have persistently focused on a few large and fairly advanced developing countries. The 20 top performers accounted for more than 80% of FDI stocks in all developing countries in the early 1990s, as well as in recent years.[2] This group consists mainly of host countries offering huge market potential (notably mainland China, Brazil and Indonesia) and high-income economies such as Hong Kong and Singapore.[3]

[2] For more details, see Nunnenkamp (2010).

[3] Note that country groups are defined as in the UNCTAD source.

Conversely, Third World locations where the need for foreign capital, technology and know-how appears to be greatest are still sidelined by multinational enterprises. The whole of Africa hosted less than 3% of worldwide FDI stocks in 2009, exactly the same share as 20 years before (Figure 2). Considering sub-Saharan Africa without the Republic of South Africa, this share has stagnated at little more than 1%. The same applies to all least-developed countries and all highly indebted poor countries – groups the international development community is particularly concerned about.

Figure 2: Major destinations and sources of FDI stocks (1990 and 2009, billion $)



Notes: Value of inward and outward FDI stocks at current prices and exchange rates. Country groups as defined in the source.

Source: UNCTAD online database

While the competition for FDI may be global, the distribution of FDI is in striking contrast with the notion of global production sharing. This is why the so-called Monterrey Consensus agreed upon at the U.N. International Conference on Financing for Development in 2002 stipulated: "A central challenge, therefore, is to create the necessary domestic and international conditions to facilitate direct investment flows […] to developing countries, particularly Africa, least developed countries, small island developing states, and landlocked developing countries, and also to countries with economies in transition" (UN 2003: 9). This is easier said than done, even though the driving forces of FDI have received considerable attention from economists.

The available empirical literature hardly provides reliable policy advice for policymakers in those developing countries that have been sidelined to date (Nunnenkamp 2010). This is partly because a consensus on the major determinants of FDI has proved to be "elusive" (Jun and Singh 1996: 70). Employing extreme bounds analysis, Chakrabarti (2001) shows that possible FDI determinants are typically not robust, but are rather fairly sensitive to small changes in the conditioning information set. Specifically, Chakrabarti (2001: 105) concludes that for each of the policy-related variables under consideration, "one can find a significant coefficient of the theoretically predicted sign only by selectively adding and combining explanatory variables, as there is not enough independent variation in any of these variables to explain cross-country differences in FDI."

Furthermore, most empirical studies are based on small and unrepresentative host-country samples, thus suffering from sample selection bias. This is particularly serious as data constraints typically exclude countries from the sample which receive little FDI or none at all. In other words, nearly all research on the driving forces of FDI focuses on the "winners," countries that have achieved at least some success in attracting FDI, whereas policy advice is most often sought by countries that had to be excluded from empirical analysis (Shatz 2003).

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