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Foreign Direct Investment Resilient in the Face of Financial Crisis

FOREIGN DIRECT INVESTMENT (FDI), THE largest component of long-term capital flows to developing countries, makes a strong contribution to growth when domestic policies are sound. The impact of FDI on the host country may vary with the sector (for example, manufacturing, services or extractive industries), the size and openness of the market, and the form of investment (from “greenfield investment” to the purchase of an existing operation), among other factors. This chapter analyzes the role of FDI in development and recovery from financial crisis:

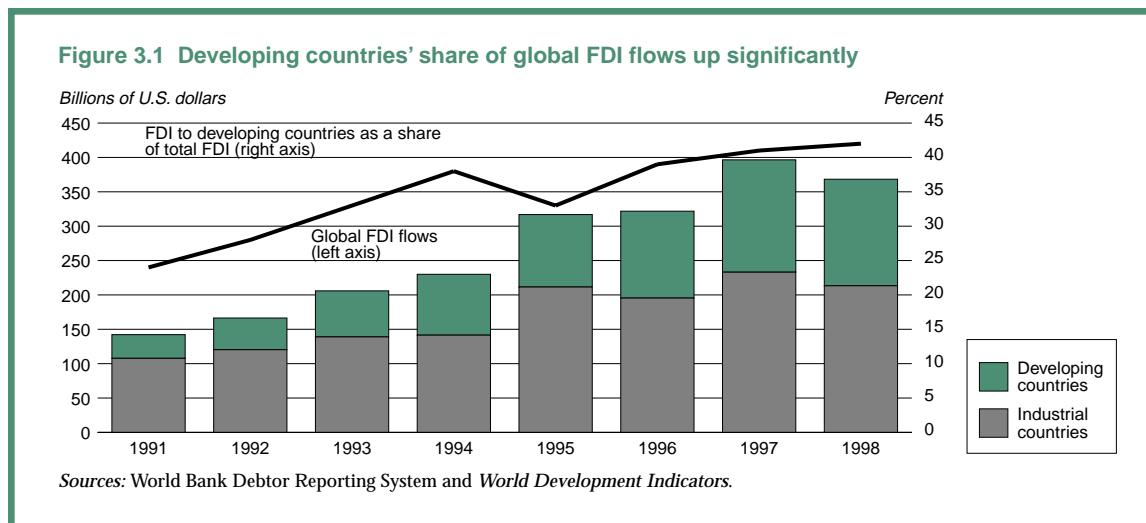
- Developing countries received two-thirds of the increase in FDI worldwide between the late 1980s and 1990s, a sharp change from the previous decade, when flows to industrial countries dominated. The countries that received the lion’s share of the surge in FDI flows during the 1990s had more open policy regimes, large markets (either domestic or through regional agreements), and relatively high incomes. A growing number of countries received significant FDI flows. No low-income country was among the top 10 FDI recipients,¹ but FDI flows accounted for a large share of total capital flows to many of the low-income oil and mineral producers.
- FDI has been much more resilient than other forms of private capital inflows in response to the financial crisis. FDI flows to the countries most affected by the financial crisis were relatively stable (except Indonesia) even as debt and portfolio equity flows fell sharply. FDI appears to owe its resilience to three factors. First are the large exchange rate depreciations that reduced production costs and asset values in

foreign currency. Second are declines in domestic asset prices. And third is the greater potential for corporate restructuring in countries affected by the crisis. These factors helped to offset the negative impact on FDI flows of the diminished market size (expressed in foreign currency) and reduced immediate prospects for growth. Although mergers and acquisitions activity declined in Indonesia, it increased in other East Asian countries following the crisis. It surged in Korea and Thailand, contributing to the financial and corporate restructuring essential for the recovery of East Asian economies.

- FDI is expected to remain the dominant source of external finance to developing countries for the foreseeable future. Even so, the financial crisis has reduced the medium-term prospects for growth in FDI flows, despite the stimulative effects of exchange rate depreciation and asset price declines, because of the increased uncertainty in world growth prospects, the slowdown in global output and trade, and the worsening outlook for growth in developing countries. Some of the East Asian crisis countries now in recovery, such as Korea and Thailand, are likely to prove an exception to this overall trend.

The Surge in FDI in the 1990s

Globalization and liberalization of developing economies have resulted in a remarkable upsurge in FDI flows in the 1990s. FDI flows to developing countries increased more than sixfold from 1990 to 1998, and their share of global FDI flows



has risen from 25 percent in 1991 to an estimated 42 percent in 1998 (figure 3.1), compared to 18 percent in the mid-1980s. The increase in FDI inflows to developing countries accounts for 65 percent of the increase in the average annual level of global FDI flows between 1986–91 and 1992–97.

For industrial countries, FDI has for the most part taken the form of acquisitions of existing assets or firms rather than construction of new facilities. Cross-border mergers and acquisitions (M&A), particularly majority-ownership transactions, surged worldwide during the 1990s.² M&A activities also became an increasingly important vehicle for FDI to developing countries during the 1990s surge, particularly in comparison to the low level of M&A activities in these countries during the 1980s. The share of developing countries in global majority-owned,

cross-border M&A sales rose significantly in the early 1990s. After some decline, the share began to increase again in 1996, reaching 19 percent in 1997. The ratio of majority-owned M&A sales to net FDI flows to developing countries followed the same pattern and reached 28 percent in 1997 (table 3.1).

M&A activities included private-to-private transactions as well as acquisitions through privatization, which increased significantly in developing countries. Privatization revenue through FDI transactions accounted, on average, for about 50 percent of M&A sales in developing countries during 1991–97.³ Privatization contributed \$21.1 billion to FDI flows in developing countries in 1997, accounting for 13 percent of total FDI, up from \$5.6 billion in 1996. In 1997 Europe and Central Asia received \$6.9 billion of FDI flows through privati-

Table 3.1 Global cross-border mergers and acquisitions, 1991–97
(billions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997
<i>Total M&A sales</i>							
World	85.28	121.89	162.34	196.37	237.18	274.61	341.65
Developing countries	13.88	38.19	64.54	67.27	68.78	88.21	107.85
<i>Majority-owned M&A sales</i>							
World	49.06	73.77	66.81	109.55	140.81	162.69	236.22
Developing countries	2.56	12.17	11.91	12.85	12.91	20.39	45.42
Share of total M&A (percent)	5.22	16.5	17.83	11.73	9.17	12.53	19.23
Ratio to FDI into developing countries (percent)	7.4	26.4	17.8	14.5	12.2	16.1	27.8
Privatization revenue through FDI in developing countries ^a	5.5	6.0	6.4	6.4	6.4	5.6	21.1

a. Privatization revenue (see appendix 4).

Source: UNCTAD World Investment Report 1998.

zation, 31 percent of total FDI flows to the region. Latin America absorbed \$11.4 billion in 1997 in privatization-related FDI, 19 percent of total FDI to the region. Sub-Saharan Africa received \$2 billion of privatization-related FDI, which accounted for 38 percent of the region's total FDI flows in 1997 (see appendix 4).

The surge of FDI inflows has also been associated with a favorable international environment, and advances in communications and transportation technologies that have expanded the scope for profitable cross-border investments (see World Bank 1997a). The simultaneous rapid growth of FDI and trade is consistent with a complementary relationship between the two, as suggested by recent research.⁴ Regional integration has also contributed positively to the growth of FDI in the recipient regions (UNCTAD 1998).⁵ The liberalization of the rules governing FDI in developing countries has encouraged higher rates of foreign investment (OECD 1998; APEC 1997). A recent study of up to 49 developing countries found that openness to international capital flows and FDI in particular had a positive impact on the level of FDI (Gastanaga, Nugent, and Pashamova 1998). More broadly, the adoption of sound economic policies encourages increased FDI flows. In the last-cited

study, policy measures such as strengthening contract enforcement and steps to reduce the risk of nationalization were found to have had positive effects on FDI.⁶ There is some concern, nevertheless, that the collapse of the negotiations over the Multilateral Agreement on Investment (box 3.1) has meant a lost opportunity to encourage further improvements in policies toward FDI.

For 25 developing countries (with populations greater than 1 million) FDI flows as a share of GDP increased by more than 2 percentage points between 1990–91 and 1996–97 (table 3.2).⁷ Most of these countries are either transition economies or Latin American countries that achieved significant improvements in the policy environment. In Latin America, this is notably the case for Peru, Nicaragua, and Trinidad and Tobago. Four Asian socialist regime countries (including China) undergoing reform are also major beneficiaries. Cambodia's policy environment has improved significantly. For several oil-rich countries (Angola, Azerbaijan, and Kazakhstan) the increase in FDI is related to the recent opening of their extractive sectors to foreign investment.

Despite such increased diversification of FDI host countries, FDI to developing countries remains highly concentrated: more than 70 percent

Box 3.1 The collapse of negotiations for the Multilateral Agreement on Investment

After a three-year effort, negotiations for the Multilateral Agreement on Investment (MAI) collapsed in December 1998. The goal of the MAI was to provide a comprehensive multilateral framework for investment, which would encourage liberalization of the rules governing FDI, and provide for a high standard of protection for international investors with effective dispute settlement procedures.

The breakdown of the MAI negotiations underlines the problems involved in reaching comprehensive agreements on international economic arrangements that affect a variety of groups, and that involve difficult tradeoffs among social, political, growth, and environmental objectives. The comprehensiveness of definitions and conditions in the pact resulted in a large number of exceptions from the general rules proposed by the participants in the negotiations, including restrictions on foreign investments in

agricultural industries, provision of subsidies, and coverage of authorities below the national level. There were objections from non-members to various constraints on the host government's ability to impose performance requirements on international investors. Opponents also argued that the agreement would promote investor rights without requiring investor responsibilities. In addition to disagreements among governments, the MAI found strong opposition from some NGOs, in particular environmental and labor groups.

Despite the difficulties raised in the MAI negotiations, there remains considerable support for international rules on investment. Proposals have been considered by some countries to incorporate certain aspects of the rules governing FDI in the World Trade Organization into the negotiations expected to begin with the November 1999 ministerial meeting.

Table 3.2 Countries with a significant increase in FDI flows, 1990–97
(FDI to GDP ratio—percent)

Region and country	Average 1990–91	Average 1996–97	Change	Average 1996–97 (US\$ million)
<i>East Asia and Pacific</i>				
Cambodia	0.0	8.0	8.0	249
Vietnam	1.3	6.8	5.5	1,650
China	1.1	4.9	3.8	42,208
Lao PDR	0.7	5.4	4.7	97
<i>Europe and Central Asia</i>				
Azerbaijan	0.0	15.6	15.6	626
Kazakhstan	0.0	5.7	5.7	1,229
Latvia	0.0	8.4	8.4	452
Estonia	0.0	4.6	4.6	208
Albania	0.0	2.7	2.7	69
Poland	0.3	3.5	3.2	4,703
Lithuania	0.0	2.8	2.8	254
Bulgaria	0.3	3.0	2.8	304
<i>Latin America and the Caribbean</i>				
Bolivia	0.8	6.9	6.2	538
Panama	1.6	7.4	5.8	634
Nicaragua	0.0	6.7	6.7	135
Chile	2.2	7.0	4.8	5,071
Peru	0.1	4.2	4.2	2,628
Venezuela	2.3	4.5	2.2	3,635
Colombia	1.2	5.0	3.9	4,629
Trinidad and Tobago	2.7	5.7	3.1	330
Brazil	0.2	1.9	1.7	15,426
Mexico	1.3	2.9	1.7	10,831
<i>Sub-Saharan Africa</i>				
Tanzania	0.0	2.4	2.4	154
Angola	1.1	4.3	3.2	325
Uganda	0.0	2.4	2.3	151

Note: Countries with populations greater than 1 million.
Source: World Bank Debtor Reporting System.

of FDI flows goes to the top 10 recipients, all of which are middle-income countries (table 3.3). The major recipients of FDI possess important advantages that have attracted large quantities of FDI flows. China's market size and increased openness continued to attract the largest volumes of FDI. Many others continued to attract significant FDI flows, given their improved policy and strong economic performance since the 1980s (Malaysia, Thailand, and Chile). For example, the ratio of FDI to GDP in Malaysia increased from less than 2 percent in 1986–87 to an average of 7 percent during 1991–96. Chile has greatly improved its policy regime governing FDI since the mid-1980s, and FDI flows have increased from less than \$1 billion in the early 1990s to \$5 billion in 1998. Latin American countries (Argentina, Brazil, and Mexico) became major recipients of FDI in the late 1980s, after emerging from the debt crisis and be-

ginning steps to improve their policy environments. Poland became a major recipient of FDI after initiating the transition toward a market economy. FDI also has gone to countries with substantial oil and mineral resources: Venezuela is again, since 1996, among the list of top 10 major recipient countries, and FDI to Russia rose significantly with the opening of its economy. Many of the countries possess a large domestic market of their own, and several are part of regional arrangements that encourage FDI inflows (box 3.1).⁸ For example, Argentina and Brazil are members of Mercosur, while China, Malaysia, and Thailand benefited from the regional economic growth in East Asia.

Low-income countries accounted for more than 7 percent of total FDI to developing countries in the early 1990s, but this share declined to 6.5 percent in 1997 (table 3.3). Despite this decline, the ratio of FDI to GDP for low-income countries

Table 3.3 Net FDI in developing countries, 1992–98
(billions of U.S. dollars)

Country or country group	1992	1993	1994	1995	1996	1997	1998 ^a
<i>Major 10 recipients</i>							
China	11.2	27.5	33.8	35.8	40.2	44.2	42.0
Brazil	2.1	1.3	3.1	4.9	11.2	19.7	24.0
Mexico	4.4	4.4	11.0	9.5	9.2	12.5	10.0
Argentina	4.0	3.3	3.1	4.8	5.1	6.6	5.6
Poland	0.7	1.7	1.9	3.7	4.5	4.9	5.5
Chile	0.9	1.0	2.6	3.0	4.7	5.4	5.0
Malaysia	5.2	5.0	4.3	4.1	5.1	5.1	5.0
Venezuela	0.6	0.4	0.8	1.0	2.2	5.1	3.7
Russia Federation	0.0	0.0	0.6	2.0	2.5	6.2	3.0
Thailand	2.1	1.8	1.4	2.1	2.3	3.7	4.8
<i>Share of total (percent)</i>							
Low-income countries	6.9	7.2	6.2	6.9	7.4	6.5	6.8
Middle-income countries	93.1	92.8	93.8	93.1	92.6	93.5	93.2
Top 10 countries	67.6	69.2	70.7	67.2	68.8	69.5	70.1
Transition economies	9.0	9.4	8.2	16.6	13.3	14.3	13.5

a. Preliminary.

Source: World Bank Debtor Reporting System.

increased from less than 0.5 percent in 1990–91 to more than 1 percent since 1995, but remained half as big as that of middle-income countries, excluding China (table 3.4). The ratio of FDI to GDP remained very small for low-income countries that do not have important mineral or oil production. FDI flows are particularly important, but highly variable, for the major mineral producers among low-income countries. FDI accounted for 77 percent of total long-term capital flows for low-income mineral producers in 1997 (table 3.5).

The surge in FDI inflows has also been accompanied by a sharp rise in FDI outflows from developing countries, although the absolute amount remains modest. FDI outflows rose from \$3 billion in 1991 to \$15 billion in 1997 (table 3.6). There

was a slight reduction in FDI outflows in 1997 from Malaysia and Thailand, where the domestic economies have been severely affected by the crisis, and a rise in outflows from Latin America, including Brazil, Chile, and Mexico.

FDI and Development

FDI inflows in developing countries tend to “crowd in” other investment and are associated with an overall increase in total investment.⁹ A cross-country regression for the period 1970–89 concluded that a 1 percentage point rise in FDI increased domestic investment by 0.5–1.3 percent (Borensztein, de Gregorio, and Lee 1998). Since

Table 3.4 FDI flows to developing countries, 1990–98
(percentage of GDP)

Country or country group	1990	1991	1992	1993	1994	1995	1996	1997	1998 ^a
Middle-income	0.6	0.8	1.1	1.5	1.9	2.0	2.2	2.7	2.6
Excluding China	0.6	0.8	0.9	1.0	1.3	1.5	1.7	2.3	2.2
Top 10 countries	0.7	1.0	1.4	2.0	2.5	2.5	2.7	3.3	3.1
Excluding China	0.7	1.0	1.1	1.0	1.4	1.6	2.0	2.7	2.7
China	1.0	1.2	2.7	6.4	6.2	5.1	4.9	4.9	4.2
Low-income non-oil exporters									
Mineral producers	0.5	1.1	1.1	1.7	1.5	2.0	2.4	2.6	2.4
Others	0.0	0.2	0.2	0.3	0.4	0.6	0.7	0.9	0.9
Low- and middle-income oil exporters	0.6	0.9	0.5	1.1	1.0	0.2	0.8	2.1	1.8

a. Preliminary.

Source: World Bank Debtor Reporting System.

Table 3.5 FDI share of long-term private flows to developing countries, 1990–98
(percent)

Country or country group	1990	1991	1992	1993	1994	1995	1996	1997	1998 ^a
Middle-income	59.0	57.0	46.2	39.9	50.3	51.6	44.8	54.2	68.2
Excluding China	63.1	56.8	44.3	29.8	40.8	42.5	36.4	49.1	62.1
Top 10 countries	50.2	54.4	44.8	39.6	58.4	57.9	50.5	59.0	72.8
Excluding China	52.9	53.5	41.5	24.4	45.8	44.5	38.3	52.6	65.2
China	43.0	58.2	52.4	69.5	76.1	82.0	80.2	72.8	89.4
Low-income non-oil exporters									
Mineral producers	78.5	81.6	59.5	69.7	51.3	63.8	66.0	76.6	—
Others	-3.3	32.5	21.3	17.0	19.2	50.5	48.0	46.8	—
Low- and middle-income oil exporters	**	82.6	209.7	67.1	64.2	69.5	74.7	95.4	—

a. Preliminary.

** Large negative number because of negative total net flows.

— Not available.

Source: World Bank Debtor Reporting System.

Table 3.6 FDI outflows from developing countries, 1991–97
(billions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997
All developing countries	3.0	7.3	9.4	10.1	11.3	11.1	14.5
China ^a	0.9	4.0	4.4	2.0	2.0	2.1	2.5
Malaysia	0.4	0.5	1.3	1.8	2.6	3.7	3.1
Chile	0.1	0.4	0.4	0.9	0.7	1.1	1.9
Brazil	1.0	0.1	1.1	1.0	1.6	1.0	1.6
Thailand	0.2	0.1	0.2	0.5	0.9	0.9	0.5
South Africa	-0.2	0.8	0.3	0.3	0.6	0.7	2.3
Mexico	0.2	0.7	0.0	1.0	0.6	0.6	1.0

a. Data on FDI outflows from China are difficult to interpret, since a portion of recorded outflows are believed to be reinvested in China.

Source: IMF balance of payments data.

the ratio of FDI to private investment is less than 30 percent in most of the major recipient countries, these results indicate that the rise in total investment typically exceeds the direct impact of an increase in FDI (table 3.7).

In addition to providing finance, FDI helps promote growth in developing economies by facilitating the transfer of technology, increasing labor force skill, promoting competition, and increasing exports. These “spillover effects” translate into greater productivity growth in the economy as a whole (World Bank 1997a). In a sample of 69 developing countries, Borensztein, de Gregorio, and Lee (1998) found that a 1 percentage point rise in the ratio of FDI to GDP increased the rate of per capita growth of the host country by 0.8 percent. Wacziarg (1998) estimated that each percentage point share of FDI in GDP was associated with an increase in per capita GDP of 0.3–0.4 percent. Blomstrom, Lipsey, and Zejan (1992) found similar results, but only for the higher-income develop-

ing countries. Tso (1998) found that the share of output of foreign firms in China’s GDP grew from 0.6 percent in 1980 to more than 16 percent in 1994. According to Sun (1998), FDI accounted for 17 percent of China’s GDP growth during the 1983–95 period.

Perhaps the most significant channel through which FDI contributes to productivity growth is increased access to technology, through market transactions such as joint ventures, licensing, and goods trade. Multinationals also improve labor skills through on-the-job training, seminars, and formal education. Some studies have shown that productivity growth was higher in foreign-owned firms (Djankov and Hoekman 1998; Kathuria 1998), and multinational enterprises are active in sectors that use relatively high levels of skilled workers (Feenstra and Hanson 1997). Technology imports by U.S. affiliates in Mexico were positively correlated with labor skills when the technology gap between domestic and foreign firms

Table 3.7 Ratio of FDI to private investment in major recipient countries, 1990–97
(percent)

Country	1990	1991	1992	1993	1994	1995	1996	1997 ^a
China	10.4	11.3	25.2	43.7	40.2	31.8	29.5	29.1
Brazil	1.2	1.9	3.8	1.9	3.6	4.1	9.4	14.3
Mexico	7.4	10.3	7.4	6.9	16.2	23.8	19.9	18.7
Argentina	13.8	10.9	12.0	7.9	6.3	11.0	10.7	11.4
Poland	0.9	2.3	6.0	15.8	15.4	23.5	22.6	20.1
Chile	10.5	14.8	13.2	11.5	27.2	27.6	35.1	29.9
Malaysia	26.1	37.4	41.3	32.8	22.0	15.5	17.5	16.5
Thailand	8.4	6.0	6.1	4.5	2.9	3.6	3.9	8.9
Venezuela	18.9	47.2	11.6	7.3	19.6	25.5	66.1	79.7
Russia Federation	—	—	—	—	1.2	3.9	3.6	8.6

a. Preliminary.

— Not available.

Sources: World Bank data and staff estimates.

was moderate (Kokko, Tansini, and Zejan 1996). Athukorala and Menon (1995) show that FDI to Malaysia facilitated technology transfer and improved the skills of the labor force. FDI also contributes indirectly to growth through emulation of foreign affiliates by domestic firms (Bernstein and Mohnen 1998; Byun and Wang 1995; Lall 1980; and Blomstrom and Sjöholm 1998) and diffusion of skills throughout the economy as employees move to domestically owned firms.

FDI can improve overall growth by promoting competition. Multinational enterprises' large size, advanced technology, and advertising expertise often enable them to invest in industries in which barriers to entry, such as large capital requirements coupled with trade restrictions, reduce the access of potential local competitors. In some cases, however, the presence of multinationals may force out less efficient local firms and ultimately reduce competition. For example, a study of the Malaysian manufacturing sector concluded that FDI was the main reason for the increase in industrial concentration (Kalirajan 1989). The impact of multinationals on sectoral concentration depends critically on the size of the market and the existence and form of barriers to entry. In the relatively large, open markets in the United States and the United Kingdom, measures of foreign presence and industrial concentration were negatively correlated (Knickerbocker 1976; Steuer and others 1973).

FDI can improve the competitive position of domestic firms through forward and backward linkages with affiliates to multinationals (Markusen and Venables 1999). The economy may benefit from price reductions in inputs to domestic pro-

duction and the development of local distributors and buyers of the multinationals' products. The entry of foreign firms also may demonstrate the potential and profitability of new products, which encourages local competitors to replicate.

FDI can help boost host country exports. Multinational enterprises are likely to face lower costs in exporting than local firms, because of the multinationals' knowledge of international market conditions and access to foreign marketing and distribution networks (Blomstrom and Kokko 1997; Aitken, Hanson, and Harrison 1997). Multinationals may help developing host countries process and export locally produced raw materials, using their marketing skills, superior technology, and general know-how. They facilitate the export of local production through their distribution networks, and they often account for a significant share of host country exports (Naya and Ramstetter 1991; Fontagne 1997).

However, developing countries do not always benefit from FDI, and the positive impact of FDI on economic growth depends on the quality of the policy environment. The correlation between FDI flows and total factor productivity growth in developing countries with high savings rates (a proxy for good economic policies) was 0.2, whereas in countries with low savings rates the correlation between FDI and productivity growth was negative (World Bank 1999). The positive association between the presence of foreign firms and total factor productivity growth is stronger for developing countries with more open trade regimes (World Bank 1997a). Also, developing countries with more open trade regimes tend to have a higher positive

correlation between FDI-to-GDP ratios and share of high-technology products in exports.

Several studies of the impact of FDI in some 30 countries, covering 183 projects over more than 15 years, found that a large minority of the projects (25 percent or more, depending on the study and methodology) had a negative impact on the economic welfare of the host country (Moran 1998). Overwhelmingly, the reason for this result was the lack of competitiveness of input and output markets, which was often influenced by host country regulations. The most important factor in determining the beneficial impact of FDI appeared to be policy actions to stimulate or retard competition. International firms are able to generate and appropriate oligopoly rents derived from barriers to entry. Protected from competition, these firms may misallocate resources and potentially leave the host country worse off than if it had not received investments.

Host country governments can maximize the benefits from FDI when they promote competitive markets through an appropriate legal and regulatory framework, and open trade and investment policies; make subsidies and incentives transparent and small; and avoid using antidumping, and domestic content regulations to protect local production.

This discussion of the indirect benefits of FDI largely reflects studies of the manufacturing sector. Some of the spillover benefits present in manufacturing FDI may also accrue from FDI in extractive industries. For example, training in many skills used in extractive industries could be useful in other sectors of the economy, and countries are likely to benefit from higher exports owing to access to multinationals' distribution and marketing channels. Although the empirical evidence of the difference in spillover effects between manufacturing and extractive FDI is difficult to find, several factors suggest that the indirect benefits of FDI may be less in extractive industries. The transfer of technology between foreign and domestic firms may be less in the extractive industries, where the technology is often embodied in extremely capital-intensive production (Song 1996). Domestic firms in the poorer developing countries may face difficulties in adopting highly capital-intensive techniques owing to limited access to finance. Extractive industries are also subject to large economies of scale, so the presence of multinationals is less

likely to spur new entrants than in manufacturing (although if there are large domestic firms, attracting multinationals may be the only way to enhance competition). Backward and forward linkages are probably less important in extractive FDI, since production in the natural resources sector requires fewer inputs of materials and intermediate goods from local suppliers because of its high capital intensity, and sales are often directed to foreign, rather than domestic, markets.

FDI Resilience during Financial Crises

FDI flows tend to be much less volatile than portfolio flows in general (box 3.2), and less likely to decline in the face of financial shocks. FDI is largely determined on the basis of long-term considerations. The integrated networks established by multinationals are built slowly, represent considerable fixed costs, and may attract additional investments despite economic fluctuations in the host economy. Many important determinants of FDI are not necessarily disrupted by financial crisis; for example, natural endowments, the policy environment, the supply of human and physical capital, infrastructure facilities, and access to intermediate or final goods markets. FDI also is less subject to capital reversals and contagion that affect other flows, since the presence of large, fixed, illiquid assets makes rapid disinvestment more difficult than the withdrawal of short-term bank lending or the sale of stock holdings.

During a crisis, "direct investors" may contribute, however, to capital withdrawals by accelerating profit remittances or reducing the liabilities of affiliates toward their mother companies.¹⁰ While these are non-FDI flows, they result from decisions by foreign investors. It is difficult to determine the extent to which foreigners involved in direct investment took out capital through non-FDI flows during the financial crisis because the data are available only with considerable delay.¹¹

In addition to long-term determinants, FDI is affected by many short-run factors (Graham and Krugman 1993), such as movements in host countries' exchange rates and asset prices and growth prospects, as well as the economic environment in FDI source countries.¹² The degree of stability of FDI flows has varied during recent financial crises, depending on the overall policy regime and the rel-

Box 3.2 The relative volatility of FDI and other capital flows

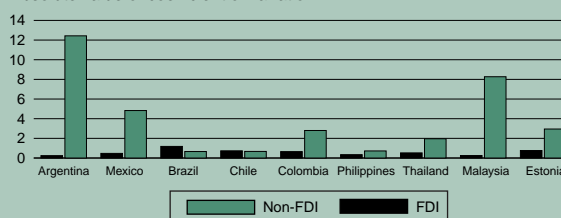
Studies have generally confirmed that FDI is less volatile than other forms of capital flows. Chuhan, Perez-Quiros, and Popper (1996) found that short-term capital responded more dramatically to financial disturbances than FDI. An analysis of flows to developing countries for the period 1986–95 found greater relative volatility in the portfolio flows than in the FDI flows (UNCTAD 1998). A recent analysis of 17 developing countries that are major recipients of FDI yielded similar results (Brewer and Nollen, forthcoming). On the basis of annual data for FDI flows and total portfolio flows for the period 1985–94, they found that in 11 of the 13 countries for which comparisons could be made, the coefficient of variation was greater for portfolio flows than for FDI flows. By contrast, Claessens, Dooley, and Warner (1995) could not find a systematic pattern in the volatility of FDI, portfolio equity, long-term debt, and short-term debt flows.

To investigate this issue further, we compared the coefficient of variation of net private non-FDI and FDI capital flows to 21 developing countries (8 from Latin America, 3 from Eastern Europe, 5 from East Asia, 3 from South Asia, and 2 from North Africa) for the major 27 episodes of capital inflow surges from 1978 to 1997. The periods of surge (before reversal) range from two to nine years, with a mean private-to-private capital inflow-to-

GDP ratio ranging from 2.2 to 11.8 percent. In two-thirds of the sample, the coefficient of variation for capital inflows as a percentage of GDP is higher for private non-FDI than for FDI flows. Considering volatility over longer periods, including pre- and post-surges, the coefficients of variations are also generally higher for non-FDI than FDI flows. This is illustrated in the figure for nine countries for the period 1990–97, where the coefficient of variation for non-FDI flows is generally much higher than for FDI flows. A notable exception is Brazil, where the FDI variability is higher owing to a surge of FDI in 1996–97 associated with privatization.

Volatility of capital inflows: FDI is more stable

Absolute value of coefficient of variation



Source: World Bank.

active importance of the short-run factors discussed above. FDI collapsed during the Latin American debt crisis of the 1980s (although by less than other long-term capital flows), declined during the Mexican peso crisis of 1995 but recovered quickly, and has been fairly resilient during the recent financial crisis.

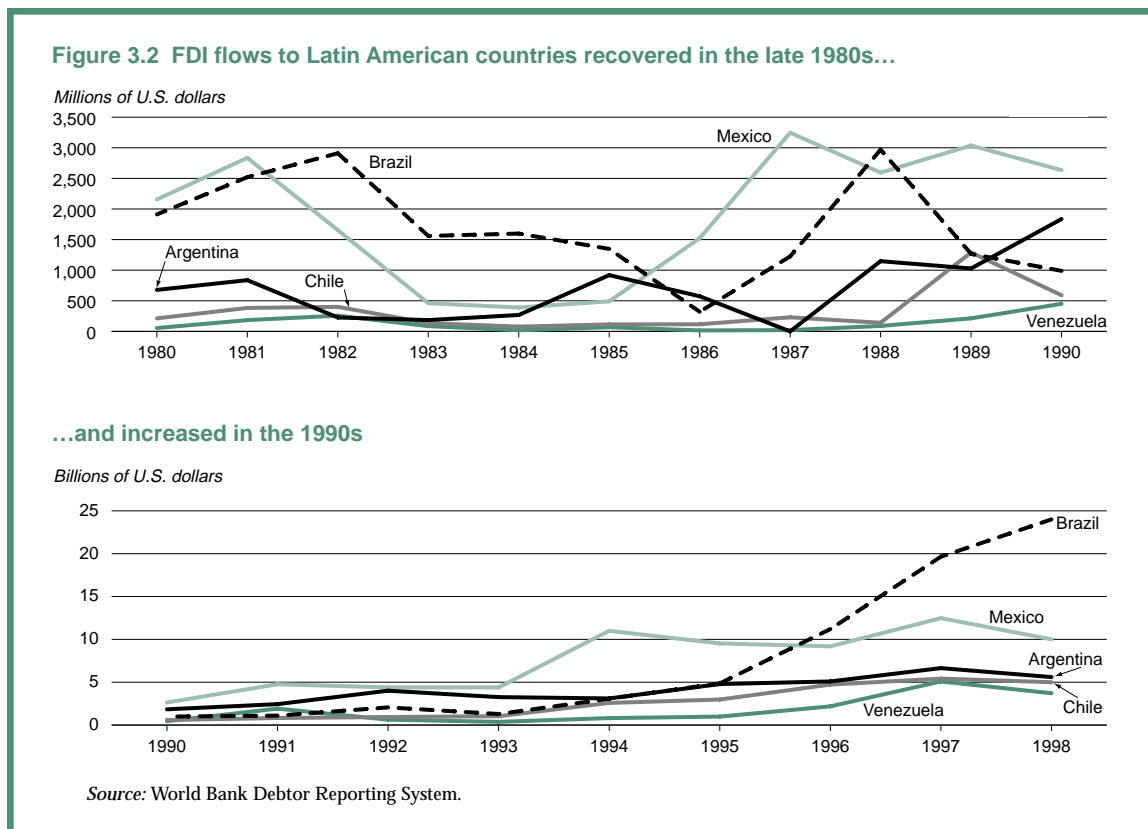
FDI flows during previous crises

The Latin American debt crisis of the 1980s. The debt crisis of the 1980s reduced FDI flows to the major Latin American countries (Argentina, Brazil, Chile, and Mexico) from \$7 billion in 1981 to \$3 billion in 1985, with particularly steep declines in Brazil and Mexico (figure 3.2). The fall in long-term flows from banks and the bond market during the 1980s debt crisis was, however, much greater than the decline in FDI. Net bond issues and commercial bank lending to the four Latin American countries dropped from \$28 billion in

1981 to \$2 billion in 1985, and was small or negative for the rest of the decade.

The Mexican peso crisis. FDI flows to Mexico fell from the peak of \$11 billion in 1994 to \$8 billion in 1996. However, by 1997 FDI flows had increased to approximately \$12 billion. FDI flows to other Latin American countries did not appear to have been affected by the peso crisis. After several years of annual fluctuations in the early 1990s, both Argentina and Brazil experienced substantial increases in FDI inflows each year from 1994 to 1997 (table 3.2).

FDI flows to Mexico were also much more stable than other private capital inflows. After a substantial surge in 1993 to \$14.3 billion, portfolio equity flows in Mexico declined to \$4.5 billion in 1994 and to \$0.5 billion in 1995; portfolio debt flows declined from \$8.9 billion in 1993 to \$6.9 billion in 1994 and \$3.9 billion in 1995, a 56 percent fall in two years. During the eight-year period



1990–97, the coefficient of variation for Mexico’s annual non-FDI private-to-private flows as percent of GDP was 4.83, compared with 0.47 for FDI.

FDI flows to developing countries during the 1997–98 financial crisis.

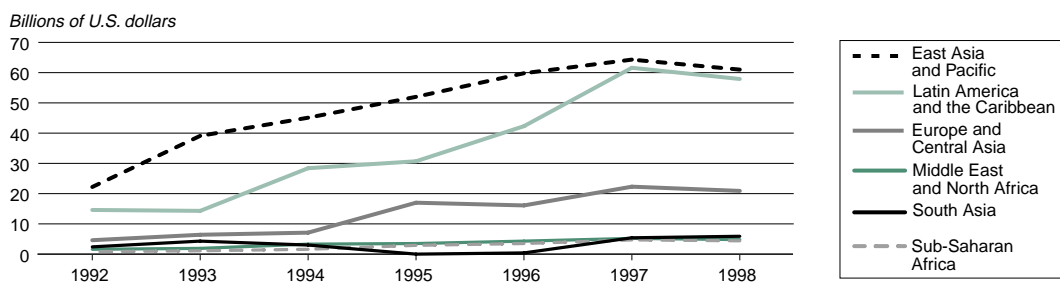
FDI flows to developing countries are estimated at \$155 billion in 1998, somewhat below the peak figure of \$163 billion reached in 1997, but have shown remarkable resilience compared with other private capital inflows (see chapter 2).

FDI flows have been particularly resilient to the East Asia and Pacific region, which was most affected by the crisis, and fell only from \$64 billion in 1997 to \$61 billion in 1998 (figure 3.3). FDI to Indonesia collapsed (see below) and FDI to China (the largest developing-country recipient of FDI) fell by \$2 billion to \$42 billion, primarily because of declines from the East Asian source countries. FDI plays a significant role in the Chinese economy, accounting for 25 percent of domestic investment, 13 percent of industrial output, 31 percent of exports, 11 percent of tax revenues, and 16

million jobs. The principal source of FDI inflows was overseas Chinese-owned firms in East Asia, including Hong Kong (China), which accounted for 60 percent of recent inflows, at least until 1995 (the latest year for which data are available). (World Bank 1997b).

FDI to Latin America and the Caribbean, the region receiving the second largest level of FDI flows, fell from \$62 billion in 1997 to \$58 billion in 1998. Significant falls in FDI to Argentina, Colombia, and Mexico were balanced by a 22 percent rise in FDI flows to Brazil as a result of large privatization projects in telecommunications and financial services. FDI flows to Europe and Central Asia fell by \$1 billion, to \$21 billion. The Central and Eastern European countries continue to attract significant FDI flows, stimulated by their ongoing strong reforms and prospects for European Union accession.¹³ Significant FDI flows are also going to a number of oil-rich countries in Central Asia, while flows to Russia fell because of the country’s economic difficulties. FDI flows to Sub-Saharan Africa remained at about \$5 billion,

Figure 3.3 FDI flows peaked in 1997



Source: World Bank Debtor Reporting System.

as FDI flows to some of the smaller countries increased while flows to South Africa dropped by more than a third.

Privatization continued to be an important source of FDI flows to developing countries in 1998, particularly in Latin America and Eastern Europe. The largest privatization among developing countries in 1998 was Telebras, Brazil's state-owned telecommunications operator, which raised \$19 billion. Telecommunications privatizations involving foreign investors also were significant in Eastern Europe, including \$1.9 billion for Rom Telecom, the Romanian state-owned telephone operator; \$1–1.5 billion for Bulgarian Telecommunications Company (BTC); and a 60 percent stake of Lietuvos Telekomas, the Lithuanian telecoms utility. One of the larger privatizations planned in Eastern Europe is the proposed sale of a 5 percent stake of Gazprom, Russia's biggest natural gas producer, half of which was sold in 1998 (for \$660 million).

Total FDI remains small relative to GDP in the Middle East and North Africa region, but an improved investment climate in many reforming countries contributed to an increase in FDI flows from \$5.4 billion in 1997 to \$5.9 billion in 1998. The largest inflows went to Egypt, Morocco, and Saudi Arabia.

Short-term factors of FDI resilience. For host countries a deterioration in their medium-term growth prospects as a result of a financial crisis is likely to reduce their attractiveness to (new plant) FDI, especially of the type aiming at the domestic market. A number of empirical studies found that the growth rate of GDP of the host country had a statistically significant positive effect on the level of

FDI (Root and Ahmed 1979; Nigh 1985; Healy and Palepu 1993; and Singh and Jun 1995).

A favorable economic environment in the FDI source countries may, however, help sustain flows of capital to developing countries during a crisis.¹⁴ Declines in asset prices, expressed in foreign currency, can also induce more acquisition of FDI if such changes make the assets more valuable for foreign investors than for domestic investors, or affect the relative ability of foreign firms to acquire assets in the crisis country (Graham and Krugman 1993). In a world of imperfect financial markets, wealth may have an effect on investment because of liquidity constraints (Hubbard 1998).¹⁵ An increase in the wealth of foreigners relative to domestic residents, which makes them less liquidity-constrained, will then have a positive impact on FDI (Froot and Stein 1991; Krugman 1998).¹⁶ The increase in relative wealth may be caused by an exchange rate depreciation, an increase in asset prices in the foreign country, or a decrease of asset prices in the domestic economy. These effects help sustain FDI during a financial crisis, but the measured impact on dollar flows is dampened by the depressed dollar prices of acquisitions.

Several studies have found that exchange rate depreciation in the host country tends to attract FDI inflows (Cushman 1988; Aizenman 1992) and that exchange rate depreciation of the source country's currency leads to a reduction in investment flows to foreign markets (Lipsev 1993; and Goldberg and Kolstad 1995). Explanations of the link between FDI and exchange rate movements have focused on changes in relative labor costs that reflect exchange rate movements (Cushman 1985;

and Culem 1988), and changes in relative wealth across countries (Froot and Stein 1991, Klein and Rosengren 1994). Blonigen (1997) finds that exchange rate movements during 1975–92 had a greater effect on Japanese acquisition investment in the United States in manufacturing activities with large investments in research and development than activities with little investment in research and development. By contrast, Healy and Palepu (1993) find no significant effect of exchange rates on FDI, and Dewenter (1995) reaches mixed results concerning the effects of exchange rates and wealth on FDI.

During the Mexican peso crisis, the large currency depreciation and decline in domestic asset prices (in dollars) helped sustain FDI flows (table 3.8). The depreciation of the peso increased the attractiveness of investments in sectors that can switch easily between producing for the domestic market and for export. The motor vehicle industry, one of the major recipients of FDI in Mexico, provides a useful illustration (Brewer 1998). Production for the Mexican domestic market declined by 56 percent from 1994 to 1996, while production for the export market increased by 28 percent. The net result was that total production declined only slightly from 855,000 units in 1994 to 795,000 units in 1996, with exports accounting for 58 percent in 1994 and 80 percent in 1996.

The acceleration of FDI after the crisis was aided by the quick domestic recovery and Mexico's dependence on the United States for FDI flows, at a time when total FDI flows from the

United States were increasing strongly, reflecting in part buoyant profitability and economic growth in the United States. The proximity and access to the large and growing U.S. market also facilitated the transfer of FDI production facilities from domestic to export markets during the crisis. As well, the expected lowering of trade and investment barriers with the 1994 NAFTA agreement opened up new opportunities for investment in Mexico and generally improved the country's medium-term prospects.

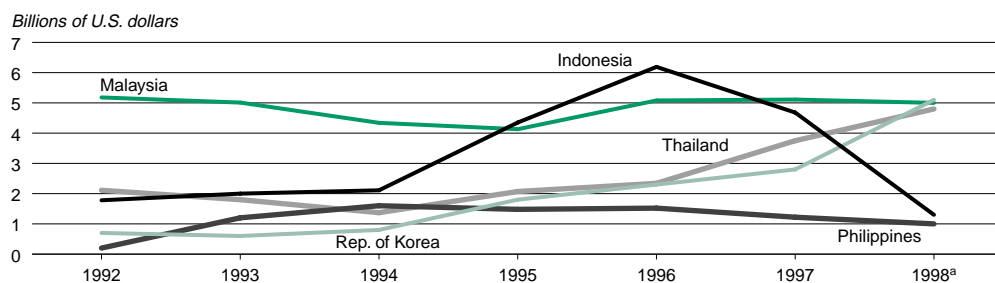
By contrast, the exchange rate depreciation and collapse of equities prices in Latin America in the early 1980s (table 3.8) were as severe as in the Mexican peso crisis and the recent East Asian crisis, but they did not help stabilize FDI because of the unfavorable international, as well as host country, environments. Mergers and acquisitions activity remained negligible. World output and trade suffered a severe recession in 1981–82 in response to the tightening of monetary policies in the United States, which resulted in a decline in global FDI flows from \$35 billion in 1981 to \$20 billion in 1982. Latin American countries during the 1980s tended also to have more restrictions on foreign investment, and a history of unstable macroeconomic policies, compared with the relatively liberalized, low-inflation countries of East Asia during the 1990s.

The slowdown in FDI to developing countries in 1998 reflects also a slowdown of FDI worldwide, which is partly explained by the slowdown and worsening prospects of world growth. Greater

Table 3.8 Output, exchange rates, and stock market prices during financial crises

	GDP (average growth rate)	U.S. dollar exchange rate (average rate of change)	Stock market prices (in U.S. dollars; percentage decline from initial date to lowest point)	
Latin America, 1980s	1981–83	1981–83	Jan. 1981	Lowest point before Dec. 1983
Argentina	0.5	–95.8	–87.1	Oct. 1982
Brazil	–2.8	–83.9	–50.7	Aug. 1983
Chile	–13.7	–50.5	–85.7	June 1983
Mexico	–4.8	–79.6	–90.7	Dec. 1982
Mexico, 1995 crisis	1994–96	1994–96	Jan. 1994	Lowest point before Dec. 1996
Mexico	–1.4	–55.6	–71.0	Mar. 1995
East Asia, 1997 crisis	1997–99	1995–97	June 1997	Lowest point to date
Korea, Rep. of	–5.6	–42.6	–73.8	June 1998
Thailand	–6.7	–38.7	–73.6	Sept. 1998
Philippines	2.0	–36.2	–74.7	Sept. 1998
Indonesia	–17.7	–76.6	–90.8	Sept. 1998
Malaysia	–4.6	–35.9	–81.5	Aug. 1998

Sources: World Bank, IMF, and Bloomberg.

Figure 3.4 FDI flows to crisis countries: Indonesia was hit hardest by the crisis

a. Preliminary.

Source: World Bank Debtor Reporting System.

global uncertainty, by increasing the option value of waiting, helps explain the decline in long-term investment commitments (Dixit and Pindyck 1994). Global GDP growth is estimated at 1.8 percent in 1998, 1.3 percentage points below the 1997 figure. The rise in the volume of global trade was 4.6 percent in 1998, down from more than 9 percent in 1997. The prospects for growth also have dimmed, as major forecasters consistently revised their projections of global output downward during late 1997 and early 1998. The deterioration in the global environment will tend to reduce FDI to developing countries, as major suppliers in industrial countries scale back their production plans because of reduced earnings and slower anticipated market growth.

FDI Flows to the East Asian Crisis Countries

FDI flows were relatively stable to four of the five East Asian countries most affected by the crisis, although these countries' experiences differed in some respects. FDI flows to Thailand and Korea rose in 1998 (figure 3.4), despite the severity of the recession in these countries, while flows declined slightly to Malaysia and the Philippines, continuing downward trends during the 1990s. The financial crisis drastically reduced FDI to Indonesia, to \$1.3 billion in 1998 compared to \$6.2 billion in 1996 and \$4.7 billion in 1997.

FDI source countries environment. The financial crisis and worsening outlook for the global economy have reduced the momentum of FDI

growth to the region. The deepening recession in Japan has had a pronounced impact on FDI flows to the five East Asian countries. Japan accounts for 30 percent of FDI flows to these countries, and total FDI outflows from Japan fell from \$20.4 billion in the first three quarters of 1997 to \$17.6 billion in the comparable period in 1998 (after increasing by more than \$10 billion from 1993 to 1997). The fall in Japanese foreign investment may reflect reduced earnings of Japanese firms with the intensification of the recession in 1998, as well as increased pessimism over the prospects for domestic demand (which would limit FDI aimed at increasing exports to the domestic market).

Domestic growth and FDI. FDI inflows (both new investments and acquisitions) designed to serve the domestic market of the crisis countries have tended to decline, as the financial crisis has greatly reduced their market size as expressed in foreign currency and lowered expectations for growth. Declines in domestic demand in 1998 were estimated to range from 21 percent to 37 percent for the five countries. While there are signs of recovery in East Asian financial markets, it is expected that most of these countries will experience either continued declines in output or growth rates of below 1 percent in 1999. It may take several years before growth rates recover to the long-term trend of output, which has probably fallen compared to precrisis expectations (World Bank 1999).

In Indonesia, the severe recession, uncertainty over economic policies, and political disturbances that reduce prospects for an early recovery have discouraged foreign investors, despite the 91 percent decline in the dollar value of equity prices

Box 3.3 Recent changes in foreign investment policies in East Asia

After the crisis hit East Asia, countries in the region eased some policies regulating foreign investments. In Thailand in late 1997, various government agencies started discussions of new regulations to allow foreigners to take majority stakes in their joint venture subsidiaries. One important regulation introduced in November 1998 by the Board of Investment eased restrictions on domestic sales by foreign-owned joint venture projects in two of their investment promoting zones. The Securities and Exchange Commission has created wholly foreign-owned funds in the property sector, to enable foreigners to own property in Thailand. However, foreigners are required to sell their land after specified time periods and are largely unable to own undeveloped land. Indonesia opened 26 industrial sectors to foreign investors in September 1998, by lifting a ban on investment by large industries in sectors previously preserved for small enterprises, including farming, fishing, food, and retail trade industries. Discussions are also underway to abolish restrictions on foreign own-

ership in the banking sector. The Indonesian government has also introduced exemption from corporate income taxes for a maximum of eight years for domestic as well as foreign investors in 22 export-oriented sectors, including chemical products and auto parts. As part of efforts to reconstruct the regional economy and promote liberalization of trade and investment, the Association of Southeast Asian Nations (ASEAN) agreed on emergency measures in December 1998, including proposals for preferential corporate tax rates and tax exemptions on imported materials for foreign investors in the region from 1999 to 2000. Korea has eased restrictions to entry of foreign investors in telecommunications and property sectors. The government also introduced the new Foreign Investment Promotion Act in November 1998, which involves protection of FDI through national treatment, reduction and exemption of corporate taxes, financial support of local government toward attracting FDI, and establishment of foreign investment zones to promote FDI.

from June 1997 to September 1998 (table 3.8). The better prospects for Korea and Thailand are reflected in the increased FDI flows in 1998.

Mergers and acquisitions in East Asia. A more attractive domestic policy environment for foreign investment (box 3.3), declines in stock markets, and the severe exchange rate depreciation contributed to the resilience in FDI flows in the East Asian countries most affected by the crisis. The dollar value of stock market indexes in the major affected countries fell from June 1997 to the lowest point in 1998, from 74 to 91 percent during

the financial crisis (table 3.8). Other asset prices—for example, property values—also have fallen significantly in some of these countries over the past few years.

In the East Asian countries most affected by the crisis, mergers and acquisitions activities in which the foreign investor acquired a majority interest increased from \$1.1 billion in 1996 to \$5.6 billion in 1997 (table 3.9). These countries' shares in total M&A in developing countries increased from 5.5 percent in 1996 to 12.4 percent in 1997.¹⁷ In sharp contrast to the 1990–96 period, in 1997

Table 3.9 Cross-border mergers and acquisitions sales in crisis countries, 1991–97
(millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997
Total FDI	9,218	9,970	10,610	10,220	13,830	17,430	17,590
Total M&A	1,554	6,737	3,030	10,156	11,145	12,638	12,300
Majority-owned M&A	139	145	475	1,027	490	1,119	5,626
Share of M&A in developing countries (percent)	5.4	1.2	4.0	8.0	3.8	5.5	12.4
Indonesia	13	42	286	199	126	118	2,328
Korea, Rep. of	14	0	0	0	0	0	724
Malaysia	57	14	139	215	16	40	198
Philippines	55	89	30	577	177	956	2,059
Thailand	0	0	20	36	171	5	317

Source: UNCTAD *World Investment Report 1998*.

about a third of FDI to the crisis countries can be accounted for by majority-interest M&A sales.

This continued attractiveness of M&A investments in the crisis countries has been supported by the ability of foreign affiliates to switch production between the domestic and foreign markets as the exchange rate depreciates. Micro-evidence suggests that multinational firms with subsidiaries in these nations have increased production for export and reduced production for local consumption.¹⁸ For example, Japanese automotive producers boosted export volumes from Thailand by 49 percent in the first 10 months of 1998, compared with the same period of 1997. Toyota Motor Corporation in Thailand initially planned to mainly serve the local market, but managed to change production patterns and triple the volume of exports in 1998 (UNCTAD 1998). Results from a survey of affiliates of U.S. firms in Asia suggest that the dollar value of sales for domestic markets has collapsed, whereas export sales are either holding constant or registering some increase (Mason, forthcoming). A survey of Japanese firms in the region produced roughly similar findings (Tejima, forthcoming).

The scope and massive requirements of restructuring of domestic banking and corporate sectors in the crisis countries increase the possibilities for FDI through mergers and acquisitions, owing not only to asset prices changes but also to the possibilities of realizing internal complementarities, which allow more effective competition with rivals (Graham and Krugman 1993). Firms that restructure most quickly will gain a competitive edge, which raises the potential return to foreign investors because there is considerable evidence that they can make a significant contribution to corporate restructuring.

The experience of the United States during the late 1980s provides a good example, in which FDI and takeovers of U.S. firms contributed positively to the resurgence in growth (Woodward and Nigh 1998), largely because the foreign investors possessed better technology or management (Graham and Krugman 1995). The transition economies provide another case in which FDI contributed to the restructuring of financial, manufacturing, and other services sectors, which led to a significant improvement in performance (box 3.4; Rojec 1998).

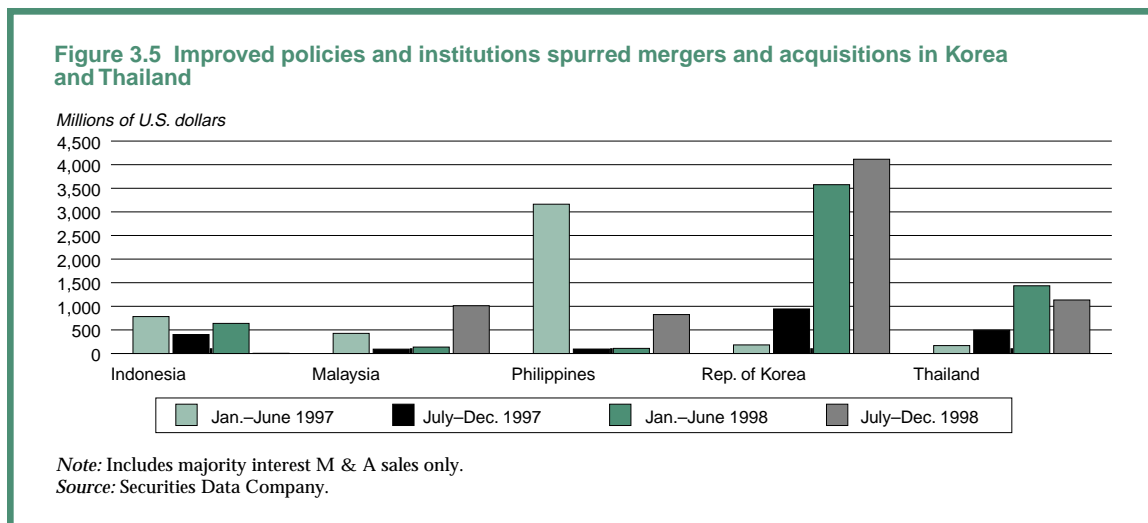
Box 3.4 Foreign investment and corporate restructuring in transition economies

A number of studies find that changes in firms' ownership can lead to corporate restructuring and improvements in financial and operating performance (Megginson and Netter 1998). Foreign investors have played a key role in restructuring domestic firms in the transition economies of Central and Eastern Europe and the former Soviet Union. For example, Hunya (1997) finds that foreign investment enterprises in the Czech Republic, Poland, and Hungary over the 1992–95 period were faster in restructuring, had a higher propensity to invest, and were often more export-oriented than domestic firms.

Banking sector in Hungary. Hungary has one of the most dynamic and competitive banking sectors in the region, as a result of major privatization opened to strategic foreign investors. As of early 1998, two-thirds of banks and three-quarters of insurance firms were in foreign hands. Foreign investors have offered technical expertise as well as financial backing, and have been more independent of domestic political influence than domestic firms. More recently, foreign investors have also entered the domestically controlled retail market of the banking industry (for example, ABN Amro of the Netherlands bought Magyar Hitel

Bank in 1996). Increased competition in the retail market has promoted the development of new services, such as debit cards, telephone banking, and flexible retail loans. Furthermore, banks have encouraged personnel training, marketing and sales improvements, and the development of electronic banking (Oxford Analytica 1998a).

Telecommunications. The telecommunications sector has benefited from a large portion of foreign investment flowing into Eastern Europe. MagyarCom—a Deutsche Telekom and Ameritech partnership—bought a 30 percent stake for \$850 million in 1993 and a 37 percent stake for \$875 million in 1995—in Matav (the Hungarian telecommunications operator). By the end of 1998, the number of lines had doubled compared with 1989, and waiting time for new lines was considerably reduced. The new company has also promoted digital exchanges and the development of cellular networks, and is pursuing its efforts to bring productivity levels (that is, number of lines per employee and revenue per employee) close to Western standards, and is developing new areas, such as ISDN lines, cable television, and home alarm systems (Oxford Analytica, 1997; Oxford Analytica, 1998b).



The declines in asset prices and the improvement in the institutional environment and greater progress of corporate restructuring resulted in a surge in M&A sales in Korea and Thailand in 1998 (figure 3.5). The two countries have significantly improved the policy and institutional environment for financial and corporate restructuring.

M&A activity in Thailand was concentrated in banking and finance, with \$1.8 billion out of a total of \$2.6 billion. The Thai banking sector has been severely affected by the crisis: commercial bank profits have been cut sharply to raise capital, and the sector is saddled with a massive debt burden and huge nonperforming loans. To restructure debts and improve transparency of the balance sheet, Bank of Asia sold its 75 percent stake to ABN Amro of the Netherlands, which became the largest foreign bank in the country. Other examples are acquisitions of Bangkok Investment by the U.S. American International Group, and Thai Danu Bank by DBS Bank in Singapore.

M&A sales also have been important in the cement sector. Thailand's three largest cement manufacturers are burdened with debts of more than \$12 billion, resulting from increased debt service, exchange losses, and falling revenues; these have led the majority of the firms to seek equity buyouts or strategic partnerships with foreign investors. Siam City Cement, the second-largest supplier, recently sold a 25 percent stake to Holdersbank of Switzerland, while Jalaprathan Cement has sold a 54 percent shareholding to Ciments Français. In

the steel industry, where capacity utilization fell to 37 percent by September 1998 and the two major integrated steel producers hold debts worth \$1.7 billion, Nakhornthai Strip Steel Mill has been acquired by a U.S. consortium, including Steel Dynamics and Enron Corporation at \$650 million.

In Korea most cross-border M&A activity was in manufacturing, with \$6.2 billion of a total of \$7.7 billion. Transactions include the acquisition of Daesant Group's Lysine Business (a chemical firm) by BASF in Germany, Samsung's Construction Equipment Arms by Volvo, and Hanwha Energy's Power Generation Business by AES from the United States. The Korean automotive sector is facing particularly severe financial problems caused by rising inventories, shortages of components, and associated difficulties of debt repayments. The liquidity crisis has triggered a process of sectoral restructuring, including the acquisition of Samsung Heavy Industries by Volvo in January 1998 and a strategic partnership between Daewoo and General Motors in February 1998. Important M&A activities also have taken place in the banking sector. In December 1998 Korea First Bank agreed to sell its 51 percent stake to a U.S. consortium led by Newbridge Capital. HSBC Holdings also agreed to acquire a 70 percent stake in Seoulbank for about \$700 million.

M&A activity in Malaysia and the Philippines increased in the second half of 1998, but has remained limited. For Indonesia, however, there was an increase in M&A in 1997 (compared to 1996),

which was followed by a collapse in 1998. The political uncertainty, collapse in economic activity, and slow progress in corporate restructuring and in improving the institutional framework prevented any increase in M&A that would have been induced by the large declines in asset prices.

All of the majority-interest M&A activity included in these data may not always be associated with corporate restructuring. More detailed data on acquisitions by U.S. investors raise questions concerning the extent to which the increase in the dollar value of M&A activity necessarily represents changes in management that would assist in restructuring. From July 1997 to June 1998 there were 37 acquisitions of non-U.S. East Asian firms by U.S. firms. Of these, 14 cases were restructurings of existing holdings by the U.S. firm—for example, the U.S. parent increasing its percentage ownership of the foreign affiliate—and 8 acquisitions were of firms that were already under foreign ownership—so only 40 percent of these transactions represented the purchase of domestically owned firms by foreigners.

The Prospects for FDI Flows

FDI accounted for 56 percent of total long-term flows in 1998, and is likely to remain the dominant form of external finance to developing countries over the medium term (particularly given the expected slow recovery of debt and portfolio equity flows—see chapter 2). However, the global crisis has reduced the prospects for FDI compared with a few years ago. Growth prospects have deteriorated worldwide, trade growth has slowed considerably, and the greater uncertainty will depress FDI flows.

Prolongation of the crisis could result in a fall in FDI flows to the East Asia and Pacific region. Several of the East Asian countries depend heavily on the region, and particularly on Japan, as a source of FDI—and a decline in Japanese aggregate demand may reduce Japanese overseas investments designed to export back to the domestic market. There are already preliminary indications that new plant and equipment FDI will decline in many of the crisis countries in the future: in the first three quarters of 1998, the number of new FDI projects recorded by government agencies that monitor foreign investment declined by 56 percent for the

Philippines, 51 percent for Thailand, and 15 percent for Malaysia, compared with the same period in 1997. The fall in the value of new FDI commitments to China, from \$111.4 billion in 1993 to \$61.7 billion in 1997, may presage a further decline in FDI to that country (although lower commitments were not reflected in a fall in actual FDI until 1998). However, the improved policy environment for FDI in East Asian countries, along with continued financial and corporate restructuring and privatization, will induce larger FDI inflows through M&A activities. For Korea and Thailand, now in recovery, this may result in an overall continued increase in FDI inflows.

Prospects are worst for FDI to Indonesia. The country pursued more restrictive policies toward FDI than neighboring countries until 1994 (Pangestu 1997), so that multinational firms in Indonesia tend not to be as well integrated into the regional and global networks of these firms as in, for example, Malaysia and Thailand. Furthermore, the severity of the economic decline and concern over potential changes in the current open policy regime will hamper recovery of FDI to Indonesia.

Reduced prospects for growth in the major Latin American countries also may lead multinationals to cut back on their investment plans, although continued progress in privatization programs will induce more FDI flows. The impact of recent events on FDI flows to Europe and Central Asia is uncertain. The financial problems affecting Russia, particularly uncertainty over debt restructuring, may lower FDI aimed at exploiting Russia's considerable natural resources. However, FDI flows may rise to the Eastern European countries scheduled for accession to the European Union and to countries pursuing privatization programs.

Notes

1. This year China was reclassified from a low-income to a middle-income country, which results in a significant fall in the volume of FDI flows to low-income countries, compared with earlier issues of *Global Development Finance*.
2. This followed a similar surge during the second half of the 1980s, which was mostly between industrial countries (Graham and Krugman 1993). For instance, during the 1980s the share of acquisitions in total FDI into the United States ranged from 60 to 89 percent (Klein and Rosengren 1994).
3. There are some limitations on data on privatization as discussed in the appendix 4, and the figures are not necessarily comparable to those on M&A sales.

4. In contrast to traditional trade theory, which has its focus on the substitutability between trade and FDI, a number of theoretical and empirical studies since the late 1970s demonstrated that FDI and exports could grow simultaneously as complements (Bergsten, Horst, and Moran 1978, Lipsey and Weiss 1981, Markusen 1983, Helpman 1984, Helpman and Krugman 1985, Grossman and Helpman 1989, 1991). A complementary relationship between exports by major multinationals and net sales of their foreign affiliates in the global market was found by Pearce (1993), as well as in other more recent studies using U.S. and Japanese data (Eaton and Tamura 1994, Kawai and Urata 1998), Japanese FDI flows and exports to North America and Southeast Asia (Wakasugi 1994), and Austrian manufacturing cross-section data (Pfaffermayr 1996).

5. Foreign investment in Mexico from the United States and other countries increased dramatically after the NAFTA agreement, and Mercosur has had a positive impact on flows to Argentina and Brazil (Blomstrom and Koko 1997). Regional integration and liberalization contributed also to increased FDI in the Asia Pacific region (Sazanami 1996, Bowles 1997).

6. Additional evidence, in background work for this report, is found based on a sample of 80 developing countries: those that substantially improved the stability of macroeconomic policies, opened their economies to external trade, and strengthened their legal and institutional frameworks experienced a significant rise in the ratio of FDI to GDP during the 1990s. With policy performance measured by an index developed at the World Bank (on a scale of 0 to 5, each country's overall rating is a weighted average of ratings for macroeconomic policy, legal and regulatory framework, effectiveness of social programs, and others), an increase in the policy performance index of 1 was associated with a 200 percent increase in the FDI-to-GDP ratio over the six-year period 1990/91 to 1996/97.

7. Seven additional small countries have also been major beneficiaries: Cape Verde, Equatorial Guinea, Guyana, Kiribati, St. Vincent and the Grenadines, Suriname, and Vanuatu.

8. UNCTAD *World Investment Report 1998* provides evidence on the importance of host country market size as a determinant of FDI.

9. Some case studies and related discussions are reported in UNCTAD *World Investment Report 1992*.

10. Measured FDI flows reflect retained earnings but are not net of repatriated earnings.

11. Graham (1998), on the basis of a series of assumptions, estimates that U.S. direct investors could have taken out as much as \$10 billion from East Asia in 1997 through non-FDI flows, but concludes that the actual figure cannot be determined at this time.

12. The role of such factors is suggested by the occurrence of surges in FDI flows for short periods of time, such as during 1978–81 in the United States and during the late 1980s in industrial countries.

13. Claessens, Oks, and Polstri (1998) find a strong statistical effect of reforms and EU accession on FDI inflows to these countries.

14. While it has been generally recognized that FDI increases with world trade and GNP growth (Graham and Krugman 1993), there has been limited empirical evidence. Singh and Jun (1995) approximated home country factors with the average industrial production index of the G-7 countries, and found the significant positive impact on FDI. In a study for 48 countries over the 1980–92 period in the manufacturing sector, Healy and Palepu (1993) find no significant effect of source-country GDP growth on FDI.

15. Such effects are usually captured empirically by including cash flow as a determinant of investment.

16. In this model there is a wealth transfer from domestic to foreign residents. In another model, in the precrisis situation, assets are valued more by domestic investors than foreign investors because of implicit government guarantees (Krugman 1998). Absent these guarantees the assets would be worth more to foreign investors because they hold specific attributes that enhance the value of these assets. After the crisis, when projects ultimately fail, relative asset values are restored to their appropriate level. Foreigners' purchases in this scenario may reflect their better access to specific technology or their superior management skills. Foreigners may pay less for these assets than they would have, had they acquired them earlier, but properties are sold at equilibrium prices and there is no wealth transfer.

17. For total M&A (including minority foreign-owned sales), however, there is no increase. Figures for the first half of 1998 show also no increase in total M&A, except for Korea (UNCTAD 1998).

18. Case studies, for example, of Honda and Toyota, are reported in UNCTAD 1998.

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