Foreign Direct Investment to Developing Countries in the Globalised World

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I. Introduction

This paper discusses the key issues related to foreign direct investment flows to developing countries in the globalised world. In particular, the paper focuses on the recent trend and direction of foreign direct investment flows to developing countries and the uneven distribution of the flows among the countries. Furthermore, the paper presents some empirical findings (based on country experiences) on why the foreign direct investments are attracted to some countries but not to many others. Finally, the paper concludes with policy implications for enhancing the developing countries' attractiveness to foreign direct investment.

II. Globalisation and Significance of Foreign Direct Investment

Globalisation of developing countries is seen by many as the key economic trend of recent times. In a liberalising and globalising world economy, a growing number of countries have received significant capital flows, mainly in form of foreign direct investment. As the remarkable growth of cross-border foreign direct investment flows has been associated with the general trends in globalisation, this section reviews the relevant key issues, such as the salient features of financial liberalisation, forces driving globalisation or integration of developing countries into the global economy, and the significance of foreign direct investment flows on the recipient countries.

A. Globalisation and Financial Liberalisation in Developing Countries

The international financial liberalisation[1] (which involves opening the capital account) has increased over the last three decades, and the industrial countries have been liberalising their capital accounts early on. However, in developing countries, the shift toward capital account liberalisation in general was slow, and many countries' private international financial transactions did not increase substantially until the early 1990s[2] (IMF, 2001).

A distinctive feature of the world economy in recent decades has been the growth of foreign direct investment, or investment by multinational firms in foreign countries in order to control assets and manage production activities in those countries. Hence, multinational corporations, in the context of a liberalising[3] world economy, played an essential role in the globalisation process by undertaking mergers and acquisitions activities. As a result, the cross-border mergers and acquisitions, particularly majority-ownership transactions, surged worldwide during the 1990s. Mergers and acquisitions activities (including private-to-private transactions as well as acquisitions through privatisation, which increased significantly in developing countries) also became an increasingly important vehicle for foreign direct investment to developing countries during the 1990s surge, particularly in comparison to the low level of mergers and acquisitions activities in these countries during the 1980s. The share of developing countries in global majority-owned, cross-border mergers and acquisitions sales rose significantly in the early 1990s.

[1] The less restrictive capital controls and higher international capital controls and higher international capital flows can increase investment possibilities, create technology spillovers, and deepen domestic capital markets.
[2] The rapid rise in liberalisation also probably reflects other factors, including the opening up of the Chinese economy, and the rapid development and growth of the newly industrialised economies, and large foreign direct investment flows to Lesotho and Nigeria, etc.
[3] The openness measure (based on the estimated gross stocks of foreign assets and liabilities as a ratio to GDP) of liberalisation suggests that the openness of developing countries as a whole accelerated sharply in the early 1990s. The increased openness reflects the more general trend toward globalisation.

Globalisation and the substantial growth of cross-border foreign direct investment capital flows in the world economy have been attributed to a number of factors. While many assert that the globalisation is associated with the reduction in barriers to international capital flows, some contend that it has been driven by a variety of other forces, such as rising trade in goods, technological innovations, growing labour mobility, greater technological spillovers, and liberalisation of domestic markets. In general, the increasing financial links across countries, and especially between industrial and developing countries, have been associated with the liberalisation of international financial markets. Moreover, globalisation in production due to technological innovations in communications and transport, coupled with better policies in developing countries, are often considered as the primary forces that drove foreign direct investment in the 1990s.

Furthermore, the increase in capital account liberalisation and the associated rapid growth of international capital flows to many developing countries have stimulated an enormous interest on the effect of the financial liberalisation on these countries. Since opening the financial markets to the rest of the world is a complex and challenging process that involves lifting restrictions on foreign direct investment flows and long- and short-term financial instruments, and that can involve significant risks, the challenge for developing countries is therefore to maximise the net benefits from liberalisation over time. Indeed, although liberalisation entails significant risks, over time liberalisation[4] can significantly raise domestic investment and create spillovers to the rest of the economy from technological transfer (particularly for foreign direct investment flows).

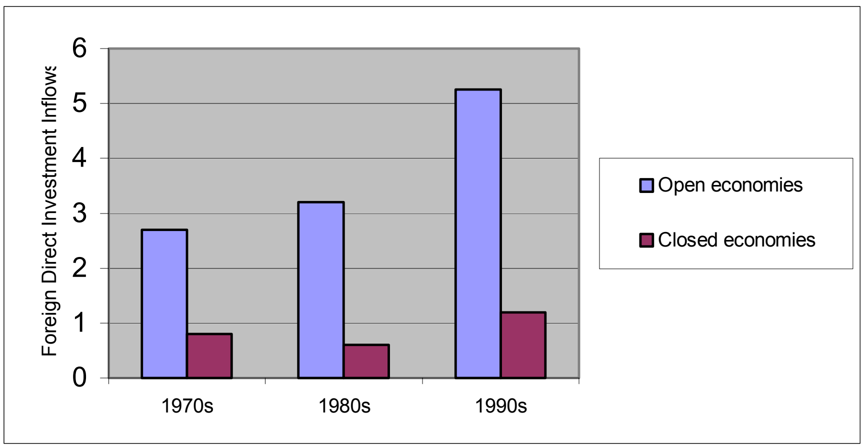
A recent study by Gastanaga, Nugent, and Pashamova (1998) supported the notion that countries with relatively liberalised capital accounts (that is, open economies) attracted more foreign direct investment flows than countries that are more closed. The study investigated up to forty nine developing countries, and found that openness[5] to international capital flows and foreign direct investment in particular had a positive impact on the level of foreign direct investment flows (see Figure 1). It also suggests

[4] In developing countries, financial liberalisation can boost growth by increasing investment and consumption.

[5] Moreover, openness to trade and open financial markets has been associated with higher growth and greater convergence across regions.

that more liberalised economies have investment ratios that are higher than closed economies and this behaviour is associated with higher foreign direct investment inflows (including many relatively poor economies with open capital accounts, which typically rely primarily on foreign direct investment inflows).

Figure 1 Foreign Direct Investment Inflows by Liberalisation in Developing Countries
(Percent of GDP)



Source: IMF, International Financial Statistics; and IMF staff calculations.

B. Significance of Foreign Direct Investment on Developing Countries

It has been increasingly recognised that growing foreign direct investment inflows can contribute to economic development and promise a variety of potential benefits to poor country recipients. Due to the potential role foreign direct investment can play in accelerating growth and economic transformation, many developing countries seek such investment to accelerate their development efforts. Consequently, foreign direct investment has become an important source of private external finance for developing countries.

The foreign direct investment can increase growth in two ways. The investment increases total investment by attracting higher levels of domestic investment. Also, through interaction of the more advanced technology with the host country's human capital, foreign direct investment is more productive than domestic investment.

Indeed, the most significant channel through which foreign direct investment contributes to productivity growth[6] is perhaps increased access to technology[7], through market transactions such as joint ventures, licensing, and goods trade.

While foreign direct investment represents investment in production facilities, its significance for developing countries is much greater. Not only can foreign direct investment add to investible resources and capital formation, but, perhaps more important, it is also a means of transferring production technology, skills, innovative capacity, and organisational and managerial practices between locations, as well as of accessing international marketing networks. In addition, the foreign direct investment can improve overall growth by promoting competition in the domestic input market. In particular, the foreign investment could increase competition in the host-country industry, and hence force local firms to become more productive by adopting more efficient methods or by investing in human and/or physical capital. Multinational firms' 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.

Moreover, foreign direct investment can boost domestic investment. For instance, a recent empirical work indicates a strong link between the volume of foreign direct investment and domestic investment. Bosworth and Collins (1999) and Mody and Murshid (2001) find that a dollar of foreign direct investment results in an almost one-dollar increase in investment. In addition to the impact of foreign direct investment on the volume of investment, the presence of foreign firms can generate important benefits for domestic firms by increasing their knowledge of, and access to, advanced technology, by improving the overall skills of the work force[8] (through valuable training opportunities to workers), and by increasing demand for domestic firms' products and the supply of inputs.

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[6] The foreign direct investment makes a strong contribution to growth when domestic policies are sound.

[7] The foreign direct investment allows the transfer of technology that cannot be achieved through financial investments or trade in goods and services.

[8] The foreign direct investment recipient country also gains employee training in the course of operating the new business, which contributes to human capital development in the host country.

Multinational corporations can promote the transfer of technology, with possible spillovers to the rest of the host economy or domestic firms. Technology spillover is a channel through which capital account liberalisation can have a positive impact. These spillovers are most clear in the case of foreign direct investment, especially through foreign firms incorporating new technologies in their subsidiaries. As new technologies are generally developed and adapted by firms in industrial countries, foreign direct investment may be the most efficient way for developing economies to gain access to them. In addition, this knowledge may become more widely available in the country over time, as employees with experience in the techniques used in foreign companies switch to other firms.

Multinationals can also improve labour skills through on-the-job training, seminars, and formal education. For example, Athukorala and Menon (1995) show that foreign direct investment to Malaysia facilitated technology transfer and improved the skills of the labour force. Foreign direct investment also contributes indirectly to growth through emulation of foreign affiliates by domestic firms and diffusion of skills throughout the economy as employees move to domestically owned firms. These spillover benefits[9] of foreign direct investment are greatest in countries with sound investment climates marked by well-developed human capital, efficient infrastructure services, sound governance, and strong institutions.

Also, the foreign direct investment spillovers appear to depend on human capital. The results from existing studies indicate that higher levels of human capital raise the benefits from foreign direct investment liberalisation and flows. For example, for a country with a high level of human capital, such as Korea, increasing the openness measure by the average gap between closed and open economies can raise growth by as much as a quarter of a percent a year (World Bank, 1999). Many studies suggest that even in poor countries with sound macroeconomic policies and limited public sector interventions in competitive markets, low levels of education and skills may limit the benefits of foreign direct investment.

[9] Profits generated by foreign direct investment contribute to corporate tax revenues in the host country. (Feldstein, 2000)

Recent analyses using macroeconomic data suggest that foreign direct investment can have a positive impact on growth, particularly when the receiving country has a highly educated workforce[10] (a measure of its absorptive capacity), allowing it to exploit foreign direct investment spillovers (Borensztein, De Gregorio, and Lee, 1998). Similarly, Borensztein, De Gregorio, and Lee (1995) and UNCTAD (1999b) find that the interaction between foreign direct investment and an indicator of human capital in cross-country regressions has a significant impact on growth in developing countries, but that foreign direct investment alone does not.

Furthermore, foreign direct investment can help boost host country exports. Multinational enterprises 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 (Fontagne, 1997).

III. Trends and Concentration of Foreign Direct Investment Flows

Since the early 1980s, world foreign direct investment flows have grown rapidly. Developing countries received two-thirds of the increase in foreign direct investment worldwide between the late 1980s and 1990s, a sharp change from the previous decade, when flows to industrial countries dominated. (World Bank, 2001)

In general, the composition of capital inflows to developing countries has shifted away from bank loans and toward foreign direct investment and portfolio investment.
In the 1970s and 1980s, bank loans were the primary form of private capital flows to developing countries. In contrast, in the 1990s, the capital flows to developing countries have been dominated by bonds and nondebt-creating flows, namely foreign direct investment and portfolio investment. Moreover, the public sector was the most important recipient of the flows in the previous periods whereas the private agents have undertaken most of the external borrowing.

[10] Also, multinational corporations tend to pay higher wages than domestic enterprises.

As shown in Table 1, Bank loans are the primary form of capital flows before 1985. However, foreign direct investment and portfolio flows are the dominant flows after 1985. In addition, foreign direct investment is expected to remain the dominant source of external finance to developing countries for the foreseeable future.

Table 1 Composition of Private Long-Term Flows, 1975-99

	Percent of Private Long-Term Flows				
	75-79	80-84	85-89	90-94	95-99
Foreign Direct Investment	18	19	49	48	55
Loans	63	62	17	7	15
Portfolio flows	5	4	11	38	29
Other	14	15	23	7	1

Source: World Bank, Global Development Finance, 2001

Also, as shown in Table 2, foreign direct investment flows to all developing countries increased by more than six-fold between 1986-90 and 1996-99. Foreign direct investment flows to the 49 countries classified by the United Nations as least developed countries, rose by similar factor (from an annual average of just $0.6 billion to $3.6 billion) over the same period. Moreover, the trends observed since foreign direct investment flows plateaued in the late 1990s have remained constant (see Table 3 and Figure 2).

Table 2 Foreign Direct Investment Flows
(billions of U.S. dollars, annual averages)

	1986-90	1991-95	1996-99
Foreign direct investment			
All developing	27.9	79.3	182.2
Least developed	0.6	1.8	3.6

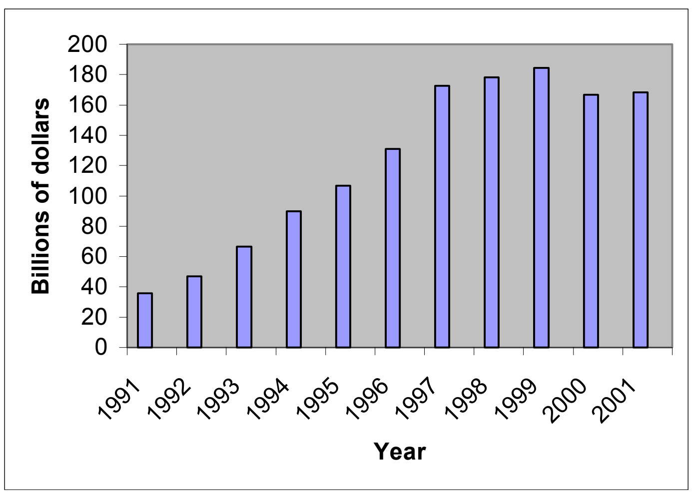
Source: UNCTAD, FDI in Least Developed Countries at a Glance,2001.

Table 3 Net Long-Term Resource Flows to Developing Countries, 1991-2001
(billions of dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000[a]	2001[b]
Net long-term resource flows	124.2	153.7	220.9	222.4	260.2	306.6	341.4	336.7	271.8	261.1	196.5
Official flows	62.2	54.3	53.4	46.0	54.1	30.3	40.7	53.4	47.4	35.3	36.5
Private flows	62.0	99.4	167.6	176.4	206.1	276.2	300.7	283.3	224.4	225.8	160.0
Capital markets	26.4	52.2	101.0	86.3	99.3	145.5	128.2	105.0	40.1	59.1	-8.3
Debt flows	18.8	38.2	50.0	51.2	63.3	96.5	98.1	89.4	5.6	8.2	-26.8
Bank lending	5.0	16.3	4.1	9.3	30.9	32.2	45.6	51.9	-23.3	-6.1	-32.3
Bond financing	11.0	11.1	36.7	38.1	30.7	62.3	49.6	40.9	29.5	16.9	9.5
Other	2.9	10.8	9.2	3.7	1.7	2.1	2.9	-3.4	-0.5	-2.5	-4.0
Equity flows	7.6	14.1	51.0	35.2	36.1	48.9	30.1	15.6	34.5	50.9	18.5
Foreign direct investment	35.7	47.1	66.6	90.0	106.8	130.8	172.5	178.3	184.4	166.7	168.2

a. Preliminary
b. Estimate
Source: World Bank Debtor Reporting System.

Figure 2 Foreign Direct Investment in Developing Countries, 1991-2001



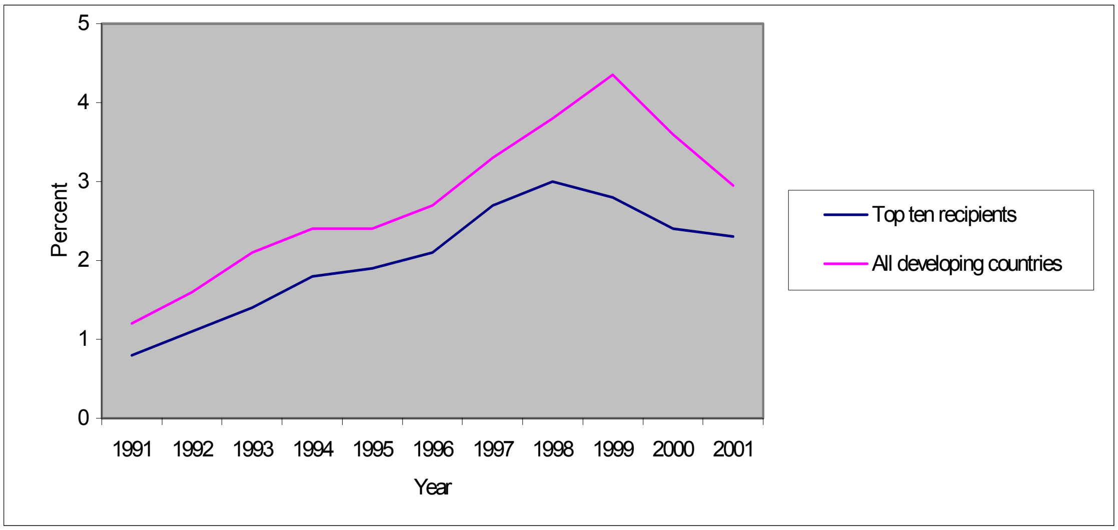
Source: World Bank, Global Development Finance: Country Tables and sources cited therein, various years.

However, despite the remarkable growth in foreign direct investment flows to developing countries as a whole, foreign direct investment flows remain highly concentrated in just a few countries. As has been true for the past few years, the top ten recipients[11] (China, Brazil, Mexico, Argentina, Poland, Chile, Malaysia, Korea, Thailand, and Venezuela) of foreign direct investment received over seventy percent

[11] China, Brazil, and Mexico alone account for about half of developing countries' foreign direct investment.

of total foreign direct investment flows to developing countries. Indeed, throughout the 1990s, the share of the top ten has never fallen below sixty-four percent. The average ratio of foreign direct investment to GDP in the top ten recipients is almost a full percentage point higher than in developing countries as a group.

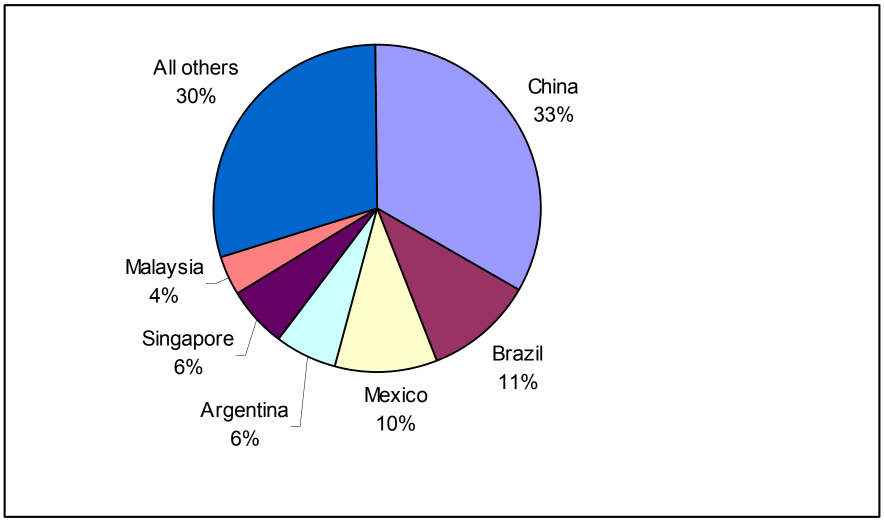
Figure 3 Foreign Direct Investment as Ratio to GDP, 1991-2001



Source: World Bank, Global Development Finance: Country Tables and sources cited therein, various years; World Bank, World Development Indicators, various years; World Bank staff estimates for 2001.

Furthermore, the bulk of capital flows to the developing countries have been directed toward Asia and Latin America. While countries in Latin America received a higher portion of portfolio flows than other regions, Asia (primarily China) received a higher portion of foreign direct investment than other regions (see Figure 4).

Figure 4 Concentration of Foreign Direct Investment Flows: Largest Developing Country Users
(*Average of 1970-2000*)



Source: IMF, International Financial Statistics; and IMF staff estimates.

IV. Empirical Evidence

As mentioned earlier, although foreign direct investment flows provide a mechanism for helping to integrate developing countries into the global economy, and have the potential to contribute to the economic growth of the host countries, the foreign direct investment have not been attracted to many developing countries. As a result, a key question naturally arises as to how to improve the developing countries' attractiveness for foreign direct investment inflows. Therefore, based on country experiences, this section attempts to address this issue by discussing the factors that appear to have helped attract foreign direct investment flows and those that tended to discourage such flows.

A. Factors that Attract Foreign Direct Investment

The major recipients of foreign direct investment possess important advantages that have attracted large quantities of foreign direct investment flows. The developing countries that received the lion's share of the surge in foreign direct investment flows during the 1990s had more open[12] policy regimes or hospitable regulatory framework, large markets, and favourable economic environment.

For example, new laws on foreign investment have been formed to permit profit repatriation since the early 1990s, while accessions to international agreements and institutions as well as conclusions of bilateral investment treaties and double taxation treaties have accelerated (UNCTAD, 2001). According to a survey conducted by UNCTAD in 1997, 26 of the 32 least developed countries in Africa in the survey had a liberal or relatively liberal regime toward the repatriation of capital. The liberalisation of the rules governing foreign direct investment in developing countries has also encouraged higher rates of foreign investment.

The foreign direct investment to some of the larger recipients has been boosted by good policies[13]. The largest foreign direct investment recipients have an average World Bank policy rating of 4.1, compared with 3.3 for other developing countries. The favourable Regulatory or Policy framework may be implemented in a variety of ways, such as through privatisation, rules regarding entry and operations, institutional environment for financial and corporate restructuring, liberal trade policy (tariffs and nontariffs) and tax policy, etc. (World Bank, 2002)

The growth rate of foreign direct investment is high to countries with good policies and rapid expansion of trade. The adoption of sound economic policies encourages increased foreign direct investment flows. Also, the policy measures such as steps to reduce the risk of nationalisation were found to have had positive effects on foreign direct investment. Given their improved policy and strong economic performance since the 1980s, many developing countries, such as Malaysia, Thailand, and Chile, continued to attract significant foreign direct investment flows. Similarly, Latin American countries (Argentina, Brazil, and Mexico) became major recipients of

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[12] Indonesia and Malaysia are defined as open using the restrictive measure from the early 1970s on (IMF, 2001).

[13] A top priority of the poorest developing countries should be to implement policies that make their country more attractive for domestic savings and investment so as to encourage foreign capital. Creating the conditions and institutions that make savings and investment attractive will over time offer poorer countries opportunities for higher living standards through capital inflows from abroad. (IMF, 2001)

foreign direct investment in the late 1980s, after emerging from the debt crisis and beginning steps to improve their policy_environments. The foreign direct investment has increased to countries with strong economic programs that liberalise the rules governing foreign direct investment. For instance, foreign direct investment has responded to government decisions on privatisation programs. Seven of the ten largest foreign direct investment recipients received more than $1 billion in foreign funds to finance privatisation activities in 1999 (World Bank, 2001).

Privatisation also appears to an important source of foreign direct investment flows to many developing countries even during the recent financial crisis (1997-98). For instance, the largest privatisation among developing countries in 1998 was Telebras, Brazil's state-owned telecommunications operator, which raised $19 billion. Other privatisation transactions include telecommunications privatisations involving foreign investors, such as $1.9 billion for Rom Telecom, the Romanian state-owned telephone operator; $1.5 billion for Bulgarian Telecommunications Company (BTC); and a 60 percent stake of Lietuvos Telekomas, the Lithuanian telecoms utility. In addition, one of the larger privatisations 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).

Similarly, Armenia pushed ahead with opening sectors to foreign investors and promoting privatisation, which led to an 80 percent upsurge in foreign direct investment as ratio to GDP over the past decade. Privatisation transactions accounted for a significant share of foreign direct investment inflows in some of these countries (15 percent in Uganda from 1992-97, and 25 percent in Bolivia from 1995-99).

Developing countries that made progress in improving the investment climate[14] during the 1990s attracted large foreign direct investment increases. In the countries where policy and institutional performance improved most, foreign direct investment as a ratio to GDP increased by 25 percent per year, while in the countries whose

[14] Business facilitation (such as investment promotion, investment incentives, improvements in amenities - for example, bilingual schools, quality of life, etc) is also considered important for foreign direct investment flows.

policies improved least, the foreign direct investment to GDP ratio increased by less than 6 percent annually (see table 4).

Table 4 Annual Change in Policy Performance and Foreign Direct Investment as Ratio to GDP, 1991-99

	Highest group	Lowest group
Improvement in policy performance index	6.6	-3.2
Increase in foreign direct investment as ratio to GDP	25.5	5.7

Note: Highest and Lowest groups of countries are based on the order of improvement in the policy performance index during the period of 1991-99. Policy performance is measured by the World Bank's Country Policy Performance Rating.
Source: World Bank, Global Development Finance: Country Tables and sources cited therein, various years; World Development Indicators, various years; World Bank staff estimates.

The relationship between improvements in the investment climate and increases in foreign direct investment flows are also seen in the experience of individual developing countries.

The surge in foreign direct investment reflects the improvements in the investment climate in the poor countries. Global foreign direct investment flows increased by 24 percent per year during 1991-2000. Developing countries as a group saw foreign direct investment flows rise 20 percent at constant prices (World Bank, 2002).

An improved investment climate in many reforming countries contributed to an increase in foreign direct investment flows from $5.4 billion in 1997 to $5.9 billion in the Middle East and North African region in 1998. The largest inflows went to the Arab of Republic of Egypt, Morocco, and Saudi Arabia. Countries that have undergone an improvement in the investment climate may see a large inflow of foreign direct investment until the stock reaches the levels desired by foreign investors. The huge surge in foreign direct investment to China with the introduction of market reforms is perhaps the most spectacular example of this phenomenon. (World Bank, 2002)

Uganda, Tanzania, and Mozambique achieved the greatest improvement in the investment climate for a sample of 23 African countries during 1992-97 (World

Economic Forum, 1998), and the ratio of foreign direct investment to GDP rose by 81 percent in Uganda, 35 percent in Tanzania, and 33 percent in Mozambique. UNCTAD (1999a) confirms that the three African countries that were most successful in attracting foreign direct investment flows (Ghana, Mozambique, and Uganda) achieved significant reduction in inflation rates and the government deficit (as a ratio to GDP). In addition, the improved policy and institutional environment along with continued financial and corporate restructuring and privatisation induced larger foreign direct investment inflows through mergers and acquisitions activities to Korea, Malaysia and Thailand.

Furthermore, changes in foreign direct investment flows in many developing countries in a liberalising and globalising world economy reflected changes in the overall economic environment, such as the market size, low-cost labour & raw materials, infrastructure (telecommunications, roads, power, etc).

Market size appears to be a major explanation of concentration of foreign direct investment flows in a few developing countries. Of the top ten developing country foreign direct investment recipients, six are also among the top ten countries in terms of GDP. For example, China has been able to attract substantial foreign direct investment flows (and the largest volumes of foreign direct investment) because of its large domestic markets, availability of low-priced Chinese labour, together with increased openness. The boom in foreign direct investment in China has also been attributed to the anticipation of accession and entrance to the World Trade Organisation. Similarly, flows to Mexico were boosted by Mexico's entrance into the North American Free Trade Agreement.

The favourable economic environment in the foreign direct investment recipient countries can help attract and sustain flows of foreign direct investment to developing countries. Several studies have found that exchange rate depreciation in the host country tends to attract foreign direct investment inflows (Cushman, 1988; Aizenman, 1992). For example, during the Mexican peso crisis, the large currency depreciation and decline in domestic asset prices (in dollars) helped sustain foreign direct investment flows. 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.

Also, the investors' view of future economic performance of the host country [the growth rate of GDP has been found to be associated with larger foreign direct investment inflows in several studies (see, for example, Nigh, 1985; World Bank, 2002), export orientation (by providing greater access to export markets), and better investment climate (in terms of sound macroeconomic policies, open regimes toward foreign direct investment, non-discriminatory frameworks for business facilitation) are crucial for attracting foreign direct investment to developing countries. For instance, the better prospects or an anticipated economic growth for Korea and Thailand are reflected in the increased foreign direct investment flows in 1998. (UNCTAD, 1998)

In addition, some examples of developing countries that have recently attracted increased foreign direct investment inflows, based on improved structural and macroeconomic performance include Bangladesh, Bolivia, and Uganda. In Bangladesh, the foreign direct investment inflows surged from minimal levels before 1995 to an annual average of $170 million during 1996-99 (about 4 percent of domestic investment). This growth followed a program of macroeconomic policy reforms undertaken since the early 1990s, and moves more recently to encourage private investment. In Bolivia, which was an early Heavily Indebted Poor Countries (HIPC) participant, the foreign direct investment flows rose after a successful program to eliminate a hyperinflation in 1985, followed by ongoing structural reform. From minimal levels in the late 1980s, foreign direct investment flows grew to an average of $818 million a year during 1996-99. At the same time, domestic gross fixed capital formation increased considerably. Foreign direct investment inflows remained high in 1999 despite short-term macroeconomic difficulties. Similarly, in Uganda, the foreign direct investment inflows began to grow in 1993, averaging $182 million per year during 1997-99, or nearly 20 percent of gross fixed capital formation. Uganda was one of the first countries to benefit from the Initiative for the Heavily Indebted Poor Countries (or HIPC Initiative) reflecting its commitment to sound macroeconomic policy-sector led development and poverty reduction. (World Bank, 2001)

B. Factors that Discourage Foreign Direct Investment

Country experiences indicate that while favourable economic environment and regulatory or policy framework help induce foreign direct investment flows, there are a number of forces that tend to discourage such flows.

Many developing countries have, during the past decade or so, begun liberalising their national policies to establish a hospitable regulatory framework for foreign direct investment by relaxing rules regarding market entry and foreign ownership, improving the standards of treatment accorded to foreign firms, and improving the functioning of markets. These core policies are important because foreign direct investment will simply not take place where it is forbidden or strongly impeded. However, changes in policies have an asymmetric effect on the location of foreign direct investment: changes in the direction of greater openness allow firms to establish themselves in a particular location. In contrast, changes in the direction of less openness (for example, nationalisation or closure to entry) will ensure a reduction in foreign direct investment. (UNCTAD, 1998)

The regulatory restrictions[15], including tariffs, quotas, tend to discourage cross-border acquisitions by multinational enterprises. Countries that impose restrictions on foreign entry and ownership and foreign exchange transactions, as well as discriminatory tax provisions, tend to hamper foreign direct investment flows. For example, in Kenya, foreign investors face multiple licensing requirements and high withholding taxes on royalties, and foreign direct investment remained less than 0.2 percent of GDP during 1991-99. Also, in Yemen, where sizeable outflows of foreign direct investment have been recorded since the mid-1990s, licensing requirements discouraged new investments, despite incentives such as tax holidays and customs exemptions.

Some of the developing countries have not achieved the improvements in the investment climate necessary to encourage higher foreign direct investment flows.

[15] Some countries impose restrictions on foreign direct investment because higher international capital flows can also create instability by leaving countries open to sudden reversals in capital flows. This risk can increase if domestic macroeconomic and financial policies are weak or inconsistent, or if financial systems are not sufficiently developed to cope with large capital flows.

While the poor prospect for growth and unfavourable economic environment have impeded the foreign direct investment flows to many countries, a number of other factors (such as the political and structural factors) have also been the important discouraging factors.

For instance, the economic uncertainty has restrained greenfield foreign direct investment in Brazil, and private sector merger and acquisition transactions has slowed down with the increasing economic difficulties in Argentina. In Indonesia[16], the severe recession, uncertainty over economic policies, and political disturbances that reduce future economic prospects have discouraged foreign investors in 1998. Similarly, Pakistan has seen a steady decline in foreign direct investment inflows since 1996 due to investor concerns over political developments.

In addition, recent analyses find that those developing countries with stronger policy environments attract a larger share of the total foreign direct investment flows to developing countries, whereas the higher levels of corruption act as a deterrent. (IMF, 2001) Moreover, in Korea, the process of corporate and financial restructuring has slowed the foreign direct investment flows.

V. Conclusion

The globalisation and integration of the world economy has resulted in a remarkable growth in the foreign direct investment flows to developing countries in the 1990s. Recognising that the foreign direct investment can contribute to economic development, many developing countries have tried to attract the foreign investment. However, the foreign direct investment flow remains highly attracted to just a few countries (such as China), while there has been limited flow to many other countries. The empirical evidence suggests that in order to induce more foreign direct investment to developing countries, the countries should focus on improving the investment climate for the foreign investors by paying special attention to measures

[16] Indonesia pursued more restrictive policies toward foreign direct investment than neighbouring countries until 1994 (Pangestu, 1997), so that multinational firms in the country tend not to be as well integrated into the regional and global networks of these firms as in, for example, Malaysia and Thailand.

that facilitate foreign direct investment. These measures that tend to increase a country's attractiveness to multinationals engaging in foreign direct investment include creating an attractive domestic policy environment and hospitable regulatory framework for foreign investment (such as open trade regime and continued progress in privatisation programs), the large market size (indicated by a country's gross domestic product), and favourable economic environment (which increases the prospect for growth) in the foreign direct investment recipient countries. Indeed, experience suggests that developing countries can increase the attractiveness to foreign direct investors by reducing the impediments to capital movements.

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