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Contents

Determinants of FDI in developing countries: has globalization changed the rules of the game?

Peter Nunnenkamp and Julius Spatz*

There is a startling gap between current thinking on, allegedly, globalization-induced changes in international competition for foreign direct investment and the lack of recent empirical evidence on shifts in the relative importance of traditional and non-traditional determinants of such investment in developing countries. We attempt to narrow this gap by making use of comprehensive survey data, collected by the European Round Table of Industrialists, on investment conditions in 28 developing countries since the late 1980s. Applying Spearman correlation coefficients and panel-data regression models, we show that surprisingly little has changed so far. Traditional market-related determinants are still dominant factors shaping the distribution of foreign direct investment. If at all, the importance of non-traditional foreign direct investment determinants has increased only modestly.

Introduction

It is widely believed that the trend towards globalized production and marketing has major implications for developing countries' attractiveness for foreign direct investment (FDI). The boom of FDI flows to developing countries since the early 1990s indicates that transnational corporations (TNCs) have increasingly discovered these host countries as competitive investment locations. At the same time, various experts argue that the determinants of, and motivations for, FDI in developing countries have changed in the process of globalization. As a result, it would no longer be sufficient to offer promising local markets in order to induce FDI inflows, and policymakers would face more complex challenges in striving for locational attractiveness for FDI (Kokko, 2002).

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It is beyond serious doubt that the rules of the game have changed in some respects. For instance, tariff-jumping FDI to serve large protected markets should have become less relevant as various developing countries have liberalized their import regimes. Apart from unilateral liberalization, successive rounds of multilateral trade liberalization have decreased the relevance of market access through FDI for many products (UNCTAD, 1998, p. 115). Recent studies also suggest that FDI is increasingly used in some industries as a means to slice up the value chain and to outsource less human capital intensive stages of the production process to lower-income countries that offer the relevant comparative advantages.[1]

Yet, the notion that traditional FDI determinants are on the decline has to be qualified. The reasoning on globalization-induced changes in FDI patterns mainly refers to the manufacturing sector. However, the recent boom of FDI in developing countries is largely due to a stronger engagement of TNCs in the services sectors of developing countries.[2] Except for some services (such as data processing and software programming), FDI in services is almost by definition market-seeking, rather than efficiency-seeking. It was encouraged by the wave of privatizing public companies in services industries such as transport, telecommunication, energy and finance in various developing countries, notably in Latin America.[3] Moreover, regional integration schemes such as Mercosur (Argentina, Brazil, Paraguay and Uruguay) provided incentives for market-seeking FDI even in manufacturing by expanding the relevant market. Hence, it remains open to debate whether the new rules of the game apply to a sufficiently large segment of FDI for non-traditional FDI determinants to be able to shape the locational attractiveness for FDI.

[1] See, e.g. Spatz and Nunnenkamp (2002) on the automobile industry; see also Dunning (2002).

[2] UNCTAD (1998, p. 113) notes "an explosion of FDI in the services sector as a result of the general trend towards the liberalization of FDI frameworks for services".

[3] Sader (1993) shows that foreign investors participated significantly in the wave of privatizations in 1988-1992. In this period, Latin America attracted almost two thirds of the foreign exchange from privatizations in the developing world.

In classifying FDI determinants as "traditional" or "non-traditional", we largely follow UNCTAD's line of reasoning. UNCTAD (1996, p. 97) argued that, as a consequence of globalization, "one of the most important traditional FDI determinants, the size of national markets, has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important". Non-traditional determinants are considered important for efficiency-seeking FDI (i.e. FDI motivated by creating new sources of competitiveness for firms and strengthening existing ones), which is regarded as the hallmark of foreign investors' responses to the changing international environment. Nevertheless, as shown below, recent empirical studies on FDI determinants in developing countries hardly address the question of globalization-induced changes. The shortage of relevant empirical studies is probably mainly because non-traditional determinants, including cost factors and complementary factors of production, are difficult to capture for a sufficiently large sample of developing countries and over a sufficiently long time span. This is in marked contrast to traditional determinants such as the size and growth of local markets.

Below, we argue that the gap between theoretical arguments and empirical evidence may be narrowed by drawing on survey results presented by the European Round Table of Industrialists (ERT, 2000). Though subjective by nature, this source offers valuable insights into various variables on which hard data are almost impossible to come by. We use these survey results, supplemented by more conventional sources, to evaluate whether the distribution of (inward) FDI stocks reveals significant changes over time. We apply Spearman rank correlation analysis in order to assess whether traditional FDI determinants have become less important, while non-traditional determinants have become more important. In the subsequent regression analysis, we examine to what extent non-traditional determinants have explanatory power for the distribution of FDI in developing countries over and above host countries' population and GDP per capita; testing for time-varying regression coefficients, we also account for changes in their additional explanatory power over time. We summarize in the final section that surprisingly little has changed so far as concerns the driving forces of FDI in developing countries.

Strong arguments, limited evidence

UNCTAD (1998, pp. 108-116) argues that globalization has led to a reconfiguration of the ways in which TNCs pursue their resource-seeking, market-seeking and efficiency-seeking objectives. The opening of markets to trade, FDI and technology flows has offered TNCs a wider range of choices on how to serve international markets, gain access to immobile resources and improve the efficiency of production systems (see also Dunning, 1999). Reportedly, TNCs are increasingly pursuing complex integration strategies, i.e. TNCs "increasingly seek locations where they can combine their own mobile assets most efficiently with the immobile resources they need to produce goods and services for the markets they want to serve" (UNCTAD, 1998, p. 111). This is expected to have two related consequences regarding the determinants of FDI:

- Host countries are evaluated by TNCs on the basis of a broader set of policies than before. The number of policies constituting a favourable investment climate increases, in particular with regard to the creation of location-specific assets sought by TNCs.
- The relative importance of FDI determinants changes. Even though traditional determinants and the types of FDI associated with them have not disappeared with globalization, their importance is said to be on the decline (UNCTAD, 1996, p. 97).

Likewise, John H. Dunning (1999) argues that the motives for and the determinants of FDI have changed. According to Dunning

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