A Better Investment Climate and Foreign Direct Investment

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Key Messages

- FDI has been an important source of international finance in developing countries. It has evolved in terms of sectoral distribution and market-seeking has become its main motivation.

- Investment climate is particularly important to attract market-seeking FDI, especially in the services sector. It is also crucial for the association between FDI and domestic investment.

- Although investment climate —therefore risks factors— in the developing world improved over the years, significant inadequacies remain in terms of “bureaucratic cholesterol,” finance and infrastructure.
FDI has been a stable source of international finance in developing countries

![Graph showing capital flows to developing countries from 1991 to 2004. The graph includes three categories: FDI, Capital market flows, and Official flows. FDI flows show a generally upward trend with fluctuations. Capital market flows are more volatile, with significant increases and decreases. Official flows are relatively stable compared to the other two categories.](image-url)
FDI flows to developing countries hit a record high in 2004 …

...but the recovery was modest in proportion to the GDP growth in developing countries
Recovery was significant in Latin America and Eastern European countries...
...mainly in Brazil, Mexico and Russia
FDI flows have shifted towards services sector

Share in total FDI Stock in 2002

Source: Global Development Finance 2004
Market-seeking activity has become the main driver of FDI

• Primary Sector: Resource-seeking investment

• Manufacturing Sector:
  – Efficiency-seeking: Consumer electronics in China
  – Market-seeking: Auto industry in China (tariff-jumping)

• Services Sector:
  – Market-seeking: Retail, infrastructure and financial services (almost 20 % of total FDI flows)
  – Efficiency-seeking: IT and business services (e.g. Call centers) – (small share in total FDI)
Important Determinants of FDI: Investors’ Perspective

- Political and economic stability
- Market size and prospects for growth
- Predictable rules for investment and a sound legal framework
- Availability of infrastructure
- Stability of the tax system is important, but tax incentives not critical in investment decisions
- Productivity of labor rather than wages per se

* Based on Capital Markets Consultative Group Survey, IMF and World Bank (2005)
Market size by itself is not decisive

Partly, due to higher risk and “red tape” in India

$ billion

China

India
Improved investment climate is associated with higher FDI…
... and with higher FDI in Services

Services FDI as a share of total FDI

Policy Performance

percent

High
Middle
Low
Improvement in investment climate in developing countries

ICRG index

Less Risky
Investment Climate in Brazil also improved after a setback in 1999.
Poor infrastructure is a prevalent problem among developing countries.

<table>
<thead>
<tr>
<th>Problem</th>
<th>Poor Countries</th>
<th>Middle Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power outages/surges from public grid</td>
<td>92</td>
<td>9</td>
</tr>
<tr>
<td>Insufficient water supply</td>
<td>28</td>
<td>10</td>
</tr>
<tr>
<td>Unavailable mainline telephone service</td>
<td>12</td>
<td>6</td>
</tr>
<tr>
<td>Transport failures</td>
<td>5</td>
<td>1</td>
</tr>
</tbody>
</table>
Improving trade logistics (ports, customs, transport) is an important agenda.

Average number of days to clear customs for sea cargo:

- Developed
- East Asia and Pacific
- Latin America and Caribbean
- Africa
- South Asia

And development assistance is key to this agenda in poor countries.

Source: International Exhibition Logistics Associates, based on a sample of countries in each region (http://www.icla.org)
### Opening Up A business

<table>
<thead>
<tr>
<th></th>
<th># of Procedures</th>
<th>Time (days)</th>
<th>Cost (%GNI per capita)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>17</td>
<td>152</td>
<td>12</td>
</tr>
<tr>
<td>Developing Countries</td>
<td>10</td>
<td>53</td>
<td>67</td>
</tr>
<tr>
<td>High Income OECD</td>
<td>7</td>
<td>28</td>
<td>8</td>
</tr>
</tbody>
</table>

### Enforcing A Contract

<table>
<thead>
<tr>
<th></th>
<th># of Procedures</th>
<th>Time (days)</th>
<th>Cost (% of debt)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>25.0</td>
<td>566.0</td>
<td>15.5</td>
</tr>
<tr>
<td>Developing Countries</td>
<td>34.0</td>
<td>419.2</td>
<td>40.9</td>
</tr>
<tr>
<td>High Income OECD</td>
<td>21.5</td>
<td>276.6</td>
<td>11.4</td>
</tr>
</tbody>
</table>
World Bank’s Role in Promoting FDI

- Monitoring and helping to improve investment climate in developing countries.

- MIGA provides investment guarantees against certain non-commercial risks (i.e., political risk insurance) to eligible foreign investors for qualified investments in developing member countries.

- Dialogue/research/cooperation with OECD, IMF, UNCTAD, WTO, regional banks and other relevant organizations.
Concluding Remarks: Prospects for FDI

- FDI flows to developing countries are expected to continue their recovery in 2005 and 2006.

- China is still the top investment destination among developing countries. However, the growth of FDI to China is slowing down reflecting increasing competition in the country and uncertainty about its currency.

- Brazil will also remain a major FDI destination although the “productivity” of these investments could be significantly improved by addressing the cost of doing business in the country.

- Other Asian countries (Malaysia, Thailand and Vietnam) as well as EU accession countries are also expected to receive higher levels of FDI in the medium term.

- Limited prospects for Africa reflecting growth potential, concerns about infrastructure, political risks, and labor productivity. This said, South-South FDI flows are growing in the region.
World Bank Sources on Business Climate:

- **The Doing Business Database** provides objective measures of business regulations and their enforcement in more than 150 economies.

- **Investment Climate Surveys**: Investment climate data in 58 countries, based on surveys of more than 28,000 firms. The surveys provide indicators of firm productivity and performance and cover management's perceptions of the severity of obstacles to operation and growth of the business.

- **Investment Climate Assessments** are comprehensive country reports that draw upon the results of Investment Climate Surveys and other available diagnostic tools. Currently available for 24 countries.


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- Thanks!