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THE ROLE OF FOREIGN DIRECT INVESTMENT (FDI) IN DEVELOPMENT AND GROWTH IN OIC MEMBER COUNTRIES

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Over the past two decades, foreign direct investment (FDI) has been sought by most, if not all, developing countries as a means of complementing the level of domestic investment, as well as securing economy-wide efficiency gains through the transfer of appropriate technology, management knowledge, access to foreign markets, increasing employment opportunities, and improving standards of living. Like other developing countries, the OIC member countries were also seeking to enhance the inflow of FDI to their economies. However, in most of these countries matters have not developed so well. Indeed, up to now, the OIC countries, as a substantial group of the world developing countries, have attracted a small share of the total FDI flowing to developing countries. The purpose of this paper is to shed light on the role of FDI in development and growth in OIC member countries and the challenges facing these countries in attracting FDI that is consistent with their overall economic development strategy.

1. INTRODUCTION

Foreign Direct Investment (FDI) is an important part of the massive private investment which is driving economic growth around the world, particularly in the past two decades. FDI is being sought by most, if not all, developing countries as a means of complementing the level of domestic investment, as well as securing economy-wide efficiency gains through the transfer of appropriate technology, management knowledge, and business culture, access to foreign markets, increasing employment opportunities, and improving living standards. To this end, policy makers have considered various incentives and policies to attract FDI, and to ensure its consistency with the domestic economic development objectives. The competition for the world's FDI flows is fierce. Foreign private investors look for certain important pointers such as freedom to control investments, convertible currencies, greater privatisation, stock

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market reforms, greater political stability, and a legal framework for doing business. Beyond these general characteristics of well-functioning market economy, investments in infrastructure, particularly transport and telecommunications, are also important. Thus, FDI flows where opportunities abound and where returns are safely realised.

Evidence indicates that countries which offer safe and profitable investment opportunities win in the global competition for this floating capital. Indeed, most FDI in the world today takes place among developed countries. However, investment in developing countries is also increasing. Since the mid-1970s, many developing countries, especially the newly industrialising Asian countries and more recently some Latin American countries, are successfully developing by opening up their economies to FDI under outward-oriented development policies. Although outward orientation alone is not a sufficient condition for rapid growth, it does create a climate favourable for FDI inflows bringing in modern managerial, production and marketing technologies which are necessary for the development of the private sector and industrial modernisation. Undoubtedly, FDI inflows were among the prime moves behind the industrial dynamism of these rapidly growing developing countries. In this context, what is crucial for outward-looking development is that FDI needs to be approached in such a manner that the developing countries' existing or potential comparative advantage can be fostered and fully maximised. Policy makers in host countries must, therefore, understand the relationship between FDI and their own goals before committing themselves to structural changes aimed at encouraging FDI.

Like other developing countries, the OIC member countries are seeking to enhance the inflow of FDI to supplement domestic savings and investment and to benefit from the economy-wide associated gains of these financial resources. This approach is part of a broad strategy aiming at sustaining high rates of economic growth, increasing employment opportunities and improving living standards. However, in most of these countries matters have not developed so well. Indeed, up to now, the OIC countries, as a substantial group of the developing countries, have attracted a small share of the total FDI flows to developing countries. Moreover, the distribution of FDI has been uneven within the OIC countries. There is a significant concentration of FDI inflows in a small number of countries. It is also noteworthy that the

most needy poor and least developed OIC countries are those which attract FDI the least.

Recent statistics indicate that while the total value of FDI flows to developing countries amounted to US$166 billion in 1998, only US$16.4 billion went to OIC countries (almost 10%). This figure compares very unfavourably with the US$45.5 billion in FDI going to one single country--China. Moreover, 71.7% of the total value of FDI flowing to OIC countries (i.e., US$11.7 billion) went to only 11 countries (out of the total 56 member countries). Furthermore, the group of OIC middle-income countries (OIC-MICs) and the group of OIC oil-exporting countries (OIC-OECs) attracted, together, more than 77% of total FDI flowing to OIC countries. In contrast, the group of OIC least developed countries (OIC-LDCs) attracted only 6.7%, despite the fact that they (21 countries) constitute 37.5% of the total number of OIC member countries.

Given this situation, the purpose of this paper is to shed light on the role of FDI in development and growth in OIC member countries and the challenges facing these countries in attracting FDI that is consistent with their overall economic development strategy. Section two presents a theoretical discussion on aspects and issues related to the role of FDI and the conditions under which it can help an economy achieve a more rapid and sustainable growth. This sets the stage for the discussion in section three of the most appropriate policies and incentives for attracting the right types of FDI. Section four documents and investigates the recent trends and developments in FDI flows to OIC countries in comparison with the developing countries. Concluding remarks are contained in section five.

2. THE ROLE OF FDI IN DEVELOPMENT AND GROWTH

FDI has not been adequately conceptualised in terms of a theory of economic development, despite the theoretical consensus on its crucial role as a catalyst of structural upgrading and economic growth in the host developing countries. There are, however, several important works that touch on some key developmental aspects of FDI by treating it either as an agent of economic growth or as a function of such growth through generating and transplanting of technology, managerial skills and linkages to the world markets (see, e.g., Reuber *et al.*, 1973;

Dunning 1981; Ozawa 1992; and Dunning 1994). Yet, those works do not constitute a well-structured theory of FDI-facilitated economic development.

Indeed, most of the literature on FDI focuses on three broad issues: (i) the reasons that push firms to internationalise; (ii) the determinants of FDI; and (iii) the relationship between FDI and economic growth. The first type of research has been the foundation of traditional international business courses. The second broad issue has been concerned with how to explain the inter-country allocation of FDI, assuming that firms make decisions that optimise their returns over a period of time. The third type of research takes the perspective of the country's general welfare, or simply its general economic, social and technological development, and examines whether FDI contributes to it or not. For the purpose of this paper, the last issue constitutes the essence of the brief discussion in this section while the second issue is partially discussed in the next section.

There is theoretical consensus and empirical evidence on the necessity of high investment rates to obtain sustainable growth. However, in the absence of a significant growth in domestic savings, a developing country may be able to achieve growth in domestic investment by utilising foreign savings. But the sustainability of such investment growth depends, in turn, on maintaining a sound domestic saving performance over the medium term (see, e.g., Aghevli *et al.*, 1990). Foreign investors seeking rates of return on their funds may be attracted to invest in developing countries with a low capital stock, and hence a high marginal productivity rate of capital, provided that investment in those economies is not viewed to be too risky. In this respect, foreign savings may get transformed into sources for funding investment in developing countries through three main financial channels: loans, equity investment, and FDI.

The least desirable form of capital flows is debt financing (loans), where the debt servicing is not directly linked to the performance of the underlying investment. In addition to the adverse incentive elements, there are also risks of time inconsistencies as debt-financed activities may produce insufficient returns in the short run to cover the necessary debt service payments (i.e., interests). On the other hand, equity financing can take one of two forms; it can be either a long-term investment type or a short-term speculative type. The latter type of

short-term return seeking portfolio investment can be a destabilising factor, especially in countries with emerging financial sectors, and may result in discouragement of foreign as well as domestic investment in the long term. Indeed, there is evidence that a significant portion of the blame for recent banking crises in developing countries can be linked to large capital inflows of a speculative nature, which tended to mask in the short run the underlying weaknesses in the financial system (see, e.g., IMF 1995).

Given these conditions, it is not surprising that FDI has been viewed as the most likely form of capital flow to exhibit long-term investment intentions due to the large fixed costs of setting-up and dismantling subsidiaries for multinational enterprises (MNEs). In this context, the argument for providing incentives for FDI can be supported on purely financial grounds. While there are some differences in opinion on the relative stability of FDI relative to other forms of capital inflows, it is generally recognised that the fixed costs associated with attracting FDI are offset by benefits in terms of reducing the potentially destabilising effects of portfolio and loan capital (see, e.g., Classen *et al*., 1995). Moreover, since the capital outflow associated with FDI (i.e., repatriated profits of the MNEs) is directly related to the returns on the investment financed by foreign funds, it is superior to debt repayment since it helps in transforming the temporary growth associated with capital inflows into investment (and hence long-term growth), rather than consumption (and hence unsustainable growth).

In light of the above theoretical arguments advanced by the theory of investment determination and the unique advantages relative to other forms of capital inflows, it seems that FDI is more conducive to enhanced sustainable growth. Considering this issue, we now turn to the factors which contribute to the superiority of FDI in terms of its spillover effects in the host economy in the long run.

2.1. Potential positive spillover effects in the host economy

As a form of international capital movement, FDI shares many of the potential benefits and costs of other forms of capital flow. However, FDI is unique in the incentive structure that it provides for foreign investors and for the host countries. Moreover, FDI is unique in producing stronger links of integration for the host country’s economy with the

global economy. These links go well beyond financial integration and factor mobility since they allow for the possibility of transfer of technology from the home countries of multinational enterprises (MNEs) to the host countries. Indeed it is this particular aspect which attracts the most attention in the current economics literature on the subject. Theoretically, there is a common argument among economists that one of the most important factors which favour FDI as a form of capital flow is its spillover effects on the rest of the host economy. Short-term capital flows may stop or reverse directions, but transfers of technology and the associated productivity impact of FDI can be long-lasting. FDI can, therefore, be a significant factor in enhancing the growth and development potential of the host developing countries.

In the above context, many economists since the mid-1980s emphasised the positive trade-related factors which favour FDI over other forms of capital flows (see, e.g., Helpman, 1984; Markusen, 1984; Brainard, 1993; and Markusen and Venables, 1996). These factors operate on both the import and the export sides. On the import side, FDI allows for importing foreign firms-specific technologies into the host country. These technologies may be in the form of capital embodied technologies in the proper sense, and may also be in the form of managerial and marketing technologies. While these technologies are not transferable through the trade of goods, they can be transferred through the establishment of MNEs in host countries. On the export side, the MNEs may provide an opportunity for domestic firms to gain access to new markets and thus enhance more indirect mechanisms for export growth in the host country. The most likely indirect increase in exports of domestic firms can occur through their output, which is embodied in the final product of the MNEs. Since the latter are likely to have an easier access to international markets due to their multinational nature, this immediately enhances the export performance of the host economy.

There is also a substantial literature identifying and evaluating the role of FDI in encouraging higher real income levels in the host economy by promoting a more efficient use of domestic resources (see, e.g., Globerman, 1979; Ozawa, 1992; Ostry and Gestrin, 1993; and Sauvant *et al.,* 1993). The theme in this literature is based on the theoretical assumption that the entry of successful foreign-owned firms, particularly MNEs, to the market of the host country can result in direct

knowledge transfer and productivity spillovers in the rest of the host country. There are a number of channels through which this result can occur in the host economy. In this context, the existing evidence is consistent in showing that MNEs, in general, tend to be larger than their domestically-owned counterparts, have higher average labour-productivity levels, and operate with higher capital-to-labour ratios (Caves, 1996 and Blomstrom and Kokko, 1996). This, in itself, contributes to higher average levels of productivity in the host economy through economies of scale and reallocation of domestic resources from less efficient to more efficient producers.

The evidence mentioned above also shows that average wage levels tend to be higher in MNEs suggesting that some portion of the higher average productivity associated with inward FDI is passed through to domestic factors of production. By sharing the domestic labour supply pool with other sectors in the host economy, the MNEs can also assist in raising the skill level of available workers for other firms in the host economy. Since a significant portion of technology is human capital embodied, this is a major source of direct knowledge transfer from MNEs to the host country. Similarly, internal trade between MNEs and domestic firms forms a direct link between foreign investors and domestic investors, which allows the latter to copy some of the better organisational and marketing technologies and practices of the former. Another channel for efficiency gains is through the increased competition in the host country market and in the regional market of the host countries, which promotes increased efficiency among domestic and regional firms. Taking all this into account and to the extent that foreign investors do not capture all of the associated increase in productivity in the form of higher profits, the host country will enjoy higher average income levels as a result of inward FDI.

2.2. Possible negative spillover effects in the host economy

The general consensus from the theoretical literature on FDI shows positive spillover effects of FDI in the host economy, but also points to the importance of monitoring the composition of FDI (see the survey in Blomstrom and Kokko, 1996). Since the spillover effects discussed above are theoretically linked to backward and forward trade links between the MNEs and domestic firms, this relative reliance on domestic firms becomes an important factor to consider. Most empirical

studies show that the potential benefits of FDI in the host economy are not automatically attained, and more important, the positive spillover effects of FDI vary quite dramatically from one country to another. In general, it has been noticed that some MNEs tend to rely more on local firms than do others. In this context, it has been shown that spillovers particularly from forward linkages are more beneficial to the host country than those associated with backward linkages, since forward linkages are more conducive to the transfer of technology and marketing know-how (Reuber *et al.,* 1973, Globerman 1979, and Ostry and Gestrin 1993).

Indeed, if FDI is not channelled to the sectors and economic activities that are essential in the development and growth process of the host economy, the associated negative effects may well outweigh the positive ones. In particular, FDI which targets domestic sales to consumers may have adverse effects on the balance of trade by increasing imports of intermediate products. In such cases, FDI would be eventually associated with reduced domestic investment and a significantly negative impact on domestic savings (Fry, 1993, p. 26). This suggests that MNEs producing intermediate goods can be more beneficial to the host economy than those producing final goods, especially if these goods target local consumption in the host country. For instance, Haddad and Harrison (1993), in a study of Moroccan manufacturing for the period 1985-1989, show that spillover effects from FDI do not take place in all industrial sectors, the effect being more evident in sectors with simpler technologies. The composition of FDI is thus of the utmost importance in determining whether or not it will have a positive effect on the host economy.

In many cases, the capital outflow associated with FDI (i.e., the repatriated profits of MNEs) is very large and only a minimum part is reinvested in the host economy. Furthermore, in some cases, the MNEs may have an unfair advantage in competing with local firms due to economies of scale. In these cases, the impact of FDI on growth may result in poorer domestic savings and investment behaviour, and thus a lower chance of attaining sustainable growth. In some other cases, FDI through MNEs causes a collapse of the domestic small and medium scale enterprises and may create a monopolistic market structure in the long run. Moreover, there is evidence that MNEs are usually unwilling to reveal their technologies to the host country and tend to keep their

research and development (R&D) operations in their mother countries. In this context, it has been shown that if MNEs use technologies that are significantly superior to the rest of the economy, they are likely to operate in "enclaves" (Kokko, 1994).

It is thus important for developing countries to attempt to attract the right types of FDI that are most likely to create positive spillover effects for the rest of the economy, and to avoid those with no, or possibly negative, spillover effects. These considerations reinforce the critical principle concerning the role of FDI in the growth process: while FDI complements domestic saving and investment, it is not a substitute for it. The policy question, then, becomes twofold: first, how to attract the more productive type of FDI to flow to the host country; and second, how to ensure that such FDI is sustainable and complements a growing level of domestic saving and investment. These two policy issues will constitute the essence of the discussion in the following section.

3. DETERMINANTS OF FDI: POLICY IMPLICATIONS

From the perspective of foreign investors, the attractiveness of the host country would be greatly enhanced by a combination of three sets of FDI determinants: (i) economic determinants; (ii) the policy framework for FDI; and (iii) business facilitation (UNCTAD 1998, p. 91). Economic determinants include traditional factors such as the availability of low-cost raw materials, skilled labour, and adequate physical infrastructure. The policy framework for FDI includes factors such as economic, political and social stability, rules and standards regarding entry, treatment and operations of foreign firms, and policies on the functioning and structure of the domestic market such as trade policy, privatisation policy, and tax policy. As the world economy becomes more open to international business transactions, countries compete increasingly for FDI not only by improving their policy and economic determinants, but also by implementing business facilitation measures.

Indeed, all these factors can be listed under a major determinant of FDI, which is the "enabling economic environment" or "investment environment" in the host country. However, the last two sets, which can be listed under institutional and policy-oriented factors, become of utmost importance as FDI determinants, especially the role of the

liberalisation of national policies (a key factor in globalisation). The importance of these policies as determinants of FDI is best illustrated by the obvious fact that FDI flows cannot take place unless they are allowed to enter a country. Yet, FDI decision-making can be viewed as an outcome of complex interactions between foreign firms and host countries. It is the characteristics of such interactions that determine a country's attractiveness in the eyes of foreign investors. In this context, it is argued that the decision to build foreign productive resources in a country involves at least two kinds of logic: the foreign firm's logic "competitiveness" and the government's logic "governability" in the host country (Hafsi and Faucher, 1996, p.7). The interface between these two types of logic--governability and competitiveness--is the key to successful FDI.

In the light of this argument, evidence shows that most of FDI flows to such countries as Indonesia and Malaysia and, to a lesser extent, Turkey are the result of a clear understanding of each party's critical concerns by the other party. Malaysia has systematically attempted to attract those firms for which the country could provide a viable strategic platform and discourage those that did not fit the country's overall development strategy. Foreign investors were attracted to the country because its conditions were clear and compatible with their own strategies (see Ghazali Atan, 1992 and Anuwar Ali, 1992). In other words, a country can only attract those types of FDI which carry with them a strategy that is compatible with its own. In contrast, governments that try to create "generally" good conditions in an attempt to catch any foreign investment usually end up with very limited amounts of FDI. Morocco, Tunisia and, to a lesser extent, Egypt are in such a situation. Closer inspection reveals that Morocco and Tunisia have done a great deal to attract foreign investors, but they have not targeted anyone in particular. By the usual determinants of FDI criteria, they should be attracting a large amount of FDI, yet they are not, which highlights the importance of the competitiveness-governability framework (see Hafsi and Faucher, 1996).

In the light of the above discussion, it seems that FDI is useful only where it is compatible with the host country's development objectives and strategies. FDI is possible only where conditions of governability are favourable and compatible with it. Host countries must, therefore, develop a clear strategy, identify those firms active in FDI whose

strategies are consistent with their own, and proceed to create the conditions that are most supportive of such strategies. Only then will the stock of FDI become significant. It seems also that the conceptual argument on the positive role of FDI does not imply that all incentives and policies for attracting FDI lead to economic growth and improved welfare in the host country.

Based on the empirical literature on this subject, the remaining discussion in the present section attempts to define which incentives and policy measures would attract the more productive type of FDI (the right type). In other words, we attempt to answer the twofold policy question raised at the end of section two: first, how to attract the more productive type of FDI; and second, how to ensure that such FDI is sustainable and complements a growing level of domestic saving and investment. In doing so, we distinguish between two types of incentives and policies for attracting FDI. First, 'positive' policies and incentives which are more conducive to achieving a sustainable growth path and result in higher inflows of the more productive form of FDI, thereby meeting the two policy conditions. Second, 'negative' policies and incentives which tend to be successful mainly in attracting speculative short term capital flows that result in uncertainty resource additionality effects and impact adversely on the macro and structural aspects of the economy and thus may hinder the host country's efforts to achieve such sustainable growth.

In general, the literature suggests that economic stability and other factors that may influence the volatility of returns on investment in the host country are important determinants of the flow of FDI (Jorgenson, 1963; Caves, 1996). In particular, surveys of MNEs and empirical analyses have shown that MNEs react adversely to volatile exchange rates in the host country. For instance, Cushman (1985) showed that MNEs are attracted to countries after a currency depreciation or in anticipation of domestic inflation in the host country. This clearly has a number of implications for the exchange rate policies (one example of the monetary policies) that host countries adopt in the hope of attracting FDI flows. On the fiscal policy front, the financial structure of FDI was shown in Shapiro (1978) to be very sensitive to the corporate tax structure in the host country. If the corporate tax rates in the host country are high, then MNEs tend to repatriate as much profits as possible to the home country and to reinvest the minimal portion of their profits in the

host country. More recently and more important, in a study of FDI flows to developing countries, Lecraw (1991) found consistent evidence that the degree of openness of the host economy is a positive factor for attracting FDI. He found that tariff levels only affected the rates of investment of MNEs attracted to the host country, but export-oriented FDI was influenced mostly by relative exchange rates.

It is then clear that the best policies and incentives for attracting FDI are incentives to 'investment' in general (domestic and foreign). Accordingly, we may summarise the "positive" policies and incentives for attracting FDI in four major policy areas. First, policies that foster macroeconomic stability and predictability. Second, trade liberalisation and exchange rate stability policies (a high degree of openness in the economy). Third, a tax structure which encourages equity and direct investment financing. Fourth, public investment and encouragement of private investment in infrastructure building and the social sectors, in particular health and education, as this improves the labour productivity.

On the other hand, most of the literature mentioned in the above discussion showed that other preferential incentives were not found to be effective in attracting the desirable type of FDI. The vast majority of such incentives were in the form of tariff protection, import quota protection, tariff exemptions or reduction on imported intermediate goods and raw materials, tax holidays, and accelerated depreciation schedules for local tax purposes. Indeed, these incentives and policies may cause negative effects rather than positive effects on the rest of the economy. Thus, they may need to be used only in a limited and careful manner. A good example in this context, where these incentives and measures have been used in many developing countries, is the free trade zones as an instrument for attracting FDI (see, e.g., Dabour 1999).

As we noted above (Lecraw, 1991), the argument for increasing the degree of openness of the host economy does not imply that any set of exemptions from trade restrictions will be a positive policy for attracting FDI. The host country may be successful in attracting FDI by offering MNEs tariff reductions and quota protection on their imports when initial tariffs on imports are high and quotas are restrictive in the host country. But this should be considered as a second best solution, since it is the combination of the two distortions (the initial trade barriers and the preferential treatment of the MNEs). More important, evidence has

shown that the type of FDI attracted by these policies is of the "tariff-jumping" type, which often targets domestic consumption in the host country and negatively affects its balance of trade (Murtha, 1991; Woodward and Rolfe, 1993). In this context, it has been shown that FDI targeting the domestic market (mostly consumption products) is strongly influenced by these types of policies. In contrast, export-oriented FDI types pay more attention to the consistency of government policy, and are not responsive to specific incentives. Therefore, it is not surprising that many developing countries have recently added export-performance requirements on FDI, which reduce the potential balance of trade deficit.

The literature also showed that the net effect of the host country's tax exemptions on MNEs is of doubtful nature. On the one hand, it provides an incentive for FDI to flow into the host country, but on the other hand, the type of FDI attracted by this incentive may be short-term (Shapiro, 1978; Oblak and Helm, 1980). Moreover, the differential tax treatment of domestic and foreign firms can harm the host country in two main directions. First, it puts further competitive pressures on domestic private investment, especially in infant industries. Second, it weakens the host country's fiscal stance by eroding its tax-base, which in turn leads to reduced public investment in education, health, and infrastructure if government expenditures are contracted, or if there are inflationary and destabilising pressures in the economy.

It is not surprising, then, to consider those types of incentive schemes as "negative" policies and incentives of attracting FDI. They can be classified in two major groups: (a) preferential exemptions from trade barriers, and (b) preferential exemptions from tax liabilities. The final expected negative effect of these policies in the host country may include the following: (i) increased domestic consumption, and a reduction in domestic savings and investment; (ii) a deterioration in the balance of trade due to the increased imports of intermediate goods; (iii) a failure of the policy of protecting domestic infant industries; and (iv) a potential net capital outflow due to repatriation of profits by the foreign firms. All these results are harmful to the overall development objectives of a developing host country.

4. DEVELOPMENTS IN FDI FLOWS

Having looked at the various theoretical issues related to the role of FDI in development and growth in the host countries, this section considers

the actual developments of FDI flows to developing countries in general and OIC countries in particular. It documents the actual trends of FDI flows to these countries in the last two decades and investigates whether FDI is actually playing its expected role in development and growth. The analysis in general is carried out in a comparative manner between the OIC countries and the developing countries as well as between different sub-groups of OIC countries and other similar sub-groups of developing countries.

4.1. The overall picture

On the one hand, the trends in FDI of the last two decades show that the developed countries are still the main home and host countries for the world flows and stock of FDI as well as for large transnational corporations (TNCs). In the 1990s, the developed countries still accounted for over two thirds of global FDI inflows and four fifths of global outflows (see UNCTAD, 1998 and Table 1 below). On the other hand, these trends show that the flows of FDI to developing countries have risen sharply, particularly in the 1990s, as many developing countries were becoming more and more attractive destinations for such capital flows. After averaging US$14.8 billion per annum in the period 1982-87, FDI flows to developing countries rose to an annual average of US$35.3 billion in the period 1987-92--a more than twofold increase (Table 1).

The decade of the 1990s witnessed a stronger expansion in FDI to developing countries. In this period, however, the trend was slightly reversed in 1995 due to the Mexican financial crisis, but then has witnessed a renewed increase in 1996. In 1996, developing countries received estimated FDI inflows of more than US$135 billion compared with almost US$34 billion in 1990 (a fourfold increase). Subsequently, this trend was dramatically reversed in 1998 due to the unfavourable contagion effects emanating from the Asian financial crisis in mid-1997 when many financial markets around the world reacted abruptly and negatively to this crisis. As a result, although FDI inflows to developing countries in 1998 increased in nominal terms, their percentage share in world FDI inflows sharply decreased from 37.7% in 1996 to 25.8% in 1998 (see Table 1 below). In contrast, the share of developed countries in world FDI sharply increased in the same period (from 58.8% in 1996

to 71.5% in 1998). That means a substantial part of FDI flows to developing countries returned back home to developed countries.

Table 1
FDI inflows, by host groups of countries

(billion US $)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
World	67.5	173.5	203.8	175.8	253.5	358.9	643.9
Developed countries	52.8 (78.1)	136.6 (78.7)	169.8 (83.3)	120.3 (68.4)	146.4 (57.5)	211.1 (58.8)	460.4 (71.5)
Developing countries	14.8 (21.8)	35.3 (20.4)	33.7 (16.6)	51.1 (29.1)	78.8 (31.1)	135.3 (37.7)	165.9 (25.8)
Least developed countries	0.20 (0.3)	0.97 (0.6)	0.60 (0.3)	1.46 (0.8)	0.82 (0.3)	1.80 (0.5)	2.95 (0.5)

Source: UNCTAD: *World Investment Report*, various years. United Nations. New York, and Geneva.
Note: Figures in brackets show the % share in world FDI inflows.

In this period, however, two important and interrelated factors need to be kept in view with regard to FDI flows to developing countries. First, they have been greatly influenced by rapid liberalisation and regulation of markets and privatisation of economic activity in most developing countries. Second, the distribution of FDI has been uneven within the developing countries. The overall picture shows that there is a significant concentration of FDI flows to certain developing countries and regions. In terms of regional distribution, the figures in Table 2 below clearly indicate that the bulk of these flows went to developing countries in Asia, particularly the region of South and East Asia. The region of Latin America and the Caribbean comes second in terms of its share in total FDI inflows to developing countries. Roughly, these two regions together attracted almost 90% of the FDI flows to developing countries in the 1990s, leaving the remaining 10 per cent to be shared among the rest of the developing world. It is also noteworthy that the most needy poor and least developed countries in the region of sub-Saharan Africa were those which attracted FDI the least.

In contrast to the 1970s and the 1980s, the rapid increase in FDI flows to developing countries in the 1990s reflects mainly the strong expansion in private capital flows to these countries, of which an important proportion has taken the form of non-debt creating flows,

notably but not exclusively FDI (see Table 3 below). However, the shift in the composition of capital inflows towards private capital has been accompanied by concentration in a small number of developing countries, mainly the so-called emerging markets[1]. It has been noticed that the 20 countries which constitute this group received, on average, 40% of total net capital inflows

Table 2
Regional distribution of FDI inflows to developing countries

(in percentages)*

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
Africa	12.7	8.5	6.8	6.2	6.7	4.4	4.8
Sub-Saharan Africa	2.2	5.1	3.4	3.1	3.8	3.0	3.2
Asia	46.1	55.5	65.6	58.0	81.0	60.6	51.2
West Asia	2.7	2.9	6.9	3.6	2.0	0.5	2.8
South and East Asia	42.5	52.6	58.7	54.2	77.9	58.7	46.6
Latin America & Caribbean	27.4	35.1	26.4	34.5	40.0	34.1	43.2
China	9.2	13.2	10.3	21.8	42.9	29.7	27.4
Oil exporting countries	30.3	30.4	27.8	29.4	32.0	20.1	16.5

Source: UNCTAD: *World Investment Report*, various years. United Nations. New York, and Geneva.
*: Percentage shares in total FDI inflows to developing countries.

during the whole past two decades. Their share went up to over 90 per cent in the 1990s, leaving the remaining 10 per cent to be shared among the rest of the developing countries, of which China alone has received over one third (Akyüz and Cornford, 1999, p. 12).

The above overall picture of the distribution of FDI inflows in developing countries emphasises the interrelationship between the two factors mentioned above. That is, the unequal distribution of FDI and its concentration in a small number of developing countries (emerging markets) have been greatly influenced by the rapid liberalisation and regulation of markets and privatisation of economic activity in these countries. Indeed, these countries are successfully developing by opening up their economies under outward-oriented development

[1] The emerging markets comprise Argentina, Brazil, Chile, China, Colombia, Ecuador, Egypt, India, Indonesia, Republic of Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Thailand, Tunisia, Turkey, Uruguay, and Venezuela.

policies. Although outward orientation alone is not a sufficient condition

Table 3
Average net capital inflows to developing countries by type of flow, 1975-1998

(% of GNP)

	1975-1982	1983-1989	1990-1998
Total net inflow			
Including China	4.91	2.87	5.00
Excluding China	5.45	2.97	4.22
Official inflows	1.58	1.57	1.03
ODA grants	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private inflows	3.33	1.29	3.97
Non-debt-creating inflows	0.42	0.55	2.21
FDI	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank credit	2.46	0.44	1.17
Short-term	1.10	0.10	0.72
Long-term	1.36	0.34	0.44

Source: Akyüz and Cornford (1999), p. 9, Table 1.

for rapid growth, it does create a climate favourable for FDI inflows bringing in modern managerial, production and marketing technologies which are necessary for the development of the private sector and industrial modernisation. Undoubtedly, FDI inflows were among the prime movers behind the industrial dynamism of these rapidly growing developing countries.

4.2. Flows of FDI to OIC countries

Like other developing countries, the OIC member countries have been seeking over the last two decades to enhance the inflows of FDI to supplement their domestic savings and investment and to benefit from the economy-wide associated gains of these financial resources. This approach was part of a broad strategy aiming at sustaining high rates of economic growth, increasing employment opportunities and improving living standards. However, in most of these countries matters have not developed so well. Indeed, up to now, the OIC countries, as a substantial

group of the world developing countries, have attracted a small share of the total FDI flowing to developing countries (see Table 4 below).

Table 4
FDI inflows to OIC countries

(million US $)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
Total OIC countries	3085	6738	7628	12065	13809	19021	16404
OIC as % of :							
World	4.6	3.9	3.7	6.9	5.4	5.3	2.5
Developed countries	5.8	4.9	4.5	10.0	9.4	9.0	3.6
Developing countries	20.9	19.1	22.6	23.6	17.5	14.0	9.9

Source: UNCTAD: *World Investment Report*, various years. United Nations. New York, and Geneva.

FDI flows to OIC countries accounted for around 20% per annum of the total FDI flows to developing countries in the 1980s. However, after the slight increase in the early 1990s, the trend was dramatically reversed in the second half of the decade. Subsequently, the trend reached its slump in 1998 due to the unfavourable contagion effects emanating from the Asian financial crisis after mid-1997. The two major OIC countries attracting the bulk of FDI flows to OIC countries over the last two decades--Indonesia and Malaysia--(see Table 5 below) were among the Asian countries that felt the brunt of the crisis. As a result, while the total value of FDI flowing to developing countries amounted to US$166 billion in 1998, only US$16.4 billion went to OIC countries (almost 10 per cent; see Table 4 above). This figure compares very unfavourably with the US$45.5 billion in FDI going to one single country--China.

In terms of the distribution of FDI inflows, similar trends to those of developing countries have been also observed in the case of OIC countries. The distribution of FDI inflows has been concentrated in a small number of OIC member countries (11 out of 56). As shown in Table 5 below, these countries attracted together more than 90 per cent of the total FDI flows to OIC countries in the periods 1982-1987 and 1987-92, and in the year 1994. Within the OIC countries, these countries are classified either as middle-income countries and/or oil-exporting countries. More important, it is noteworthy that the majority of these countries (namely Indonesia, Malaysia, Turkey, Morocco, Tunisia, and

Egypt) are included in the group of emerging markets mentioned in the footnote above. It is obvious, then, that these countries are those which have more market-oriented economies, more liberalised and regulated markets, more privatised economic activities, and a better infrastructure and attractive concessions to foreign investors.

Table 5
Concentration of FDI inflows in some OIC countries

(million US$)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
Egypt	809	806	734	459	1256	636	1076
Indonesia	282	999	1093	1777	2109	6194	-356
Malaysia	844	2387	2333	5183	4342	5078	3727
Morocco	42	203	227	423	551	354	258
Nigeria	371	845	588	897	1959	1539	1500
Oman	139	103	141	104	76	75	50
Pakistan	86	227	244	335	419	919	497
Saudi Arabia	149	-35	1864	-79	350	-1129	2400
Tunisia	150	160	76	526	432	238	650
Turkey	92	578	684	844	608	722	807
Kazakhstan	-	17	-	100	660	1137	1158
Total	2964	6290	7984	10569	12762	15688	11767
% of OIC countries	96.1	93.1	104.7	87.6	92.4	82.5	71.7

Source: UNCTAD: *World Investment Report*, various years. United Nations. New York, and Geneva.

Another observation in terms of the distribution of FDI inflows in the OIC countries is that there is also a significant concentration of FDI flows in certain groups within the OIC countries. As shown in Table 6 below, the group of OIC middle income countries (OIC-MICs) and the group of OIC oil-exporting countries (OIC-OECs) attracted, together, more than 90 per cent of the total FDI flows to OIC countries in almost all the years over the last two decades. The remaining part of less than 10 per cent was left to be shared by the other two groups: the group of OIC least developed countries (OIC-LDCs) and the group of OIC countries in transition (OIC-TCCs). It is, then, noteworthy that the most needy poor and least developed OIC countries are those which attract FDI the least. In the year 1994, for instance, the group of OIC-LDCs attracted only 1.4 per cent of the total FDI flows to OIC countries,

despite the fact that they (21 countries) constitute 37.5 per cent of the total number of OIC member countries. However, this share increased to 6.5 per cent in 1998 compared with the decreasing share of the OIC-MICs group. This may be explained by the fact that OIC-LDCs were less affected by the Asian crisis in 1997 than the countries of the other two groups. Lastly, it is noteworthy that in the context of their efforts to transform their economies under outward-oriented polices, the group of OIC countries in transition (OIC-TCCs) were quite successful in attracting FDI in the second half of the 1990s.

Table 6
FDI inflows to OIC subgroup countries

(million US $ and %)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
OIC-LDCs	57 (1.8)	297 (4.4)	-73 (-1.0)	850 (7.0)	200 (1.4)	420 (2.2)	1065 (6.5)
OIC-MICs	2470 (80.1)	5402 (80.2)	5355 (70.2)	9802 (81.2)	10129 (73.4)	14508 (76.3)	7380 (45.0)
OIC-OECs	555 (18.0)	1020 (15.1)	2346 (30.8)	1253 (10.4)	2547 (18.4)	2049 (10.8)	5374 (32.8)
OIC-TCCs	0 (0)	17 (0.3)	0 (0)	160 (1.3)	933 (6.8)	2044 (10.7)	2585 (15.8)

Source: UNCTAD: *World Investment Report*, various years. United Nations. New York, and Geneva.
Note: Figures in brackets show the % share in total FDI inflows to OIC countries.

The above picture shows that the OIC countries were not very successful in attracting a large share of the FDI flowing to developing countries in the past two decades. In fact, when individual country data is considered, it would appear that FDI in many OIC countries, particularly in the OIC-LDCs, is really insignificant (see Appendix 1). This picture implies that although FDI has an important role in development, this role cannot be considered unless a certain level of development is realised in the host country. The flow of FDI to OIC countries has also been small in relation to the size of their economies, which implies that the majority of these countries were not able to capitalise sufficiently on the potential developmental benefits of FDI. By bringing in capital, new technology and export market linkages, FDI is regarded as an important catalyst of growth and industrial development. However this role of FDI, particularly in terms of the ratio of FDI to

gross fixed capital formation in OIC countries, seems to be very weak in most of these countries. As shown in Appendix 2, the ratios of FDI to gross fixed capital formation are very low in most OIC countries. Except for a few cases in the late 1990s, these ratios are extremely low in OIC-LDCs. By contrast, the share of FDI in gross fixed capital formation is rather significant in OIC-MICs and OIC-OECs, especially in the cases of the above mentioned 11 countries.

Given the above situation, the attraction of FDI is a particularly important policy for almost all OIC countries. Thus, in the context of their efforts to increase economic growth rates in a sustainable manner, greater emphasis has to be placed on attracting FDI by improving the overall enabling economic environment and by putting in place specific incentives and policies for such investment.

5. CONCLUDING REMARKS

The analysis in this paper establishes three main concluding remarks of relevance to the role of FDI in development and growth in the OIC member countries. They can be summarised as follows:

First, up to now, the OIC countries, as a substantial group of developing countries, have not attracted sufficient FDI inflows. They have attracted a small share of the total FDI flowing to developing countries (almost 10 per cent in 1998). There is a significant concentration of these inflows (more than 90 per cent of the total OIC FDI inflows) in a small number of countries (almost 11 out of a total of 56). The majority of them (Indonesia, Malaysia, Turkey, Morocco, Tunisia, and Egypt) are included in the group of the world emerging markets in which FDI inflows have been greatly influenced by rapid liberalisation and regulation of markets and privatisation of economic activities. Moreover, the most needy poor and least developed OIC countries are those which attract FDI the least.

This picture shows that the OIC countries were not very successful in attracting a large share of the FDI flowing to developing countries in the past two decades. The flow of FDI to OIC countries has also been small in relation to the size of their economies, which implies that the majority of these countries were not able to capitalise sufficiently on the potential developmental benefits of FDI. Indeed, this disappointing

picture is a part of a broader overall investment picture in the OIC countries as a group that has been associated with heavy dependence on external influences and low levels both in terms of volume and productivity. Therefore, OIC countries need to do a lot to create an environment conducive to FDI through attaining appropriate levels of savings and investment as well as conducting appropriate economic and institutional policy reforms.

Second, in the light of the literature and empirical evidence on the role of FDI in development and growth in the host developing countries, the analysis of this paper confirms that FDI can help OIC economies meet their economic objectives. FDI could be very useful in various respects to OIC countries as it enables them to supplement their domestic savings and investment and to benefit from the associated transfers of technology, management knowledge, business culture, and access to foreign markets. FDI should be approached as a boost to growth and development but not as a reliable substitute for domestic sources of investment and savings. Attracting FDI should be a part of a broad strategy aimed at sustaining high rates of economic growth, increasing employment opportunities and improving living standards. However, FDI is basically determined by competitive market conditions. Foreign investors seek mainly more profitable and secured investment opportunities, and hence they are attracted towards locations that can provide these requirements. Unfortunately, this is not the case for the majority of the OIC countries.

Attraction of FDI is, therefore, a particularly important policy issue for almost all OIC member countries. In the context of their efforts to increase economic growth rates in a sustainable manner, greater emphasis has to be placed on attracting FDI by improving the overall enabling economic environment and by putting in place specific incentives for such investment.

Third, there is therefore an urgent need to enhance the current trend of FDI inflows to OIC countries. However, while the need for FDI is sharp, it does not justify using any incentive instrument particularly that which might fragment the tax system and undermine the macroeconomic policy stance. In fact, there is a wide range of “positive” incentives and policies available to OIC countries to enhance inflows of FDI, the effectiveness of which would be facilitated by improving the enabling

investment environment through sound macroeconomic policies, strengthened institutions and intensification of structural reforms, rapid liberalisation and regulation of markets, and privatisation of economic activities.

As progress is made on these issues, there will be less need for OIC countries to resort to "negative" incentives and policies for attracting FDI, which not only undermine fiscal, financial and balance of payments structures but also tend to attract the less productive type of FDI. More important, greater cooperation and harmonisation among OIC member countries would assist in this regard by creating an attractive overall environment for longer-term developmental FDI, which can contribute significantly to attaining the growth and development goals of the member countries.

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Appendix 1
FDI inflows to OIC countries

(million US $)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
Bangladesh	1	2	3	18	11	14	317
Benin	-	3	1	1	-	25	26
Burkina Faso	1	2	1	-0.3	-	17	14
Chad	17	6	-	2	27	23	35
Comoros	1	3	-	-2	-	-	-
Djibouti	-	-	-	2	1	20	25
Gambia	-	6	-	6	10	12	14
Guinea	2	20	18	20	-	-	15
Guinea-Bissau	1	2	2	6	-	-	8
Maldives	2	5	6	7	9	8	7
Mali	1	-1	-7	-8	17	84	30
Mauritania	6	4	7	8	2	4	6
Mozambique	2	12	9	25	35	73	213
Niger	14	22	-1	56	-11	15	-
Sierra Leone	-20	12	32	-6	-3	19	30
Somalia	7	-2	6	-	-	-	-
Sudan	6	-6	-31	-	-	-	10
Togo	6	9	18	-2	3	21	5
Uganda	-	-	-6	3	88	120	210
Yemen	10	198	-131	714	11	-60	100
Total OIC LDCs	**57**	**297**	**-73**	**849.7**	**200**	**420**	**1065**
Cameroon	115	4	-113	29	-9	89	94
Egypt	809	806	734	459	1256	636	1076
Guyana	2	49	8	147	107	92	44
Indonesia	282	999	1093	1777	2109	6194	-356
Jordan	43	21	38	41	3	16	223
Lebanon	4	2	6	4	23	64	230
Malaysia	844	2387	2333	5183	4342	5078	3727
Morocco	42	203	227	423	551	354	258
Pakistan	86	227	244	335	419	919	497
Senegal	-1	18	-3	21	67	10	20
Surinam	-16	-119	-43	-54	-30	7	10
Syria	18	67	71	67	251	89	100
Tunisia	150	160	76	526	432	238	650
Turkey	92	578	684	844	608	722	807
Total OIC MICs	**2470**	**5402**	**5355**	**9802**	**10129**	**14508**	**7380**

Appendix 1 (continued)
FDI inflows to OIC countries

(million US $)

	Annual average						
	1982-87	**1987-92**	**1990**	**1992**	**1994**	**1996**	**1998**
Algeria	-7	-	-	10	22	447	500
Bahrain	45	58	-4	-9	-31	47	10
Brunei	1	1	3	4	6	11	4
Gabon	78	56	74	127	-100	312	300
Iran	-105	-129	-362	-170	2	26	300
Iraq	3	2	-	-1	-	-	-
Kuwait	-3	7	-6	35	-	347	-10
Libya	-152	52	159	165	69	209	150
Nigeria	371	845	588	897	1959	1539	1500
Oman	139	103	141	104	76	75	50
Qatar	-2	10	5	40	132	35	70
Saudi Arabia	149	-35	1864	-79	350	1129	2400
U.A.E	41	52	-116	130	62	130	100
Total OIC OECs	**555**	**1020**	**2346**	**1253**	**2547**	**2049**	**5374**
Albania	-	-	-	20	53	90	45
Azerbaijan	-	-	-	-	22	591	1085
Kazakhstan	-	17	-	100	660	1137	1158
Kyrgyzstan	-	-	-	-	38	47	102
Tajikistan	-	-	-	-	10	16	30
Turkmenistan	-	-	-	-	100	108	80
Uzbekistan	-	-	-	40	50	55	85
Total OIC LDCs	**-**	**17**	**-**	**160**	**933**	**2044**	**2585**
Total OIC Countries	**3085**	**6738**	**7628**	**12064.7**	**13809**	**19021**	**16404**

Source: World Investment Development Report, various years. United Nations. New York and Geneva.
Note: The shaded rows indicate concentration of FDI inflows in some OIC countries.

Appendix 2
The ratio of FDI inflows to gross fixed capital formation

(in percentages)

	Annual average						
	1981-85	1987-92	1990	1992	1994	1996	1997
OIC LDCs							
Bangladesh	-		0.1	0.1	0.3	0.3	2.9
Benin	0.2	1.1	0.3	3.0	-	6.6	7.2
Burkina Faso	0.3	0.3	0.1	-	0.3	2.8	2.1
Chad	24.0	4.8	-	1.8	24.0	20.7	33.2
Comoros	0.1	5.5	0.7	2.1	0.4	1.0	1.4
Djibouti	0.1	0.5	-	1.8	2.6	30.2	40.2
Gambia	-0.2	11.2	-0.4	8.8	16.5	20.3	20.8
Guinea	0.1	4.4	4.5	4.0	-	4.6	3.4
Guinea-Bissau	1.1	0.3	3.5	10.0	0.3	2.0	27.3
Maldives	-2.1		11.3	10.9	-	-	-
Mali	2.2	-0.3	-1.4	-	3.9	13.6	6.6
Mauritania	4.7	2.1	3.3	3.0	1.3	2.6	0.5
Mozambique	0.2	1.6	1.1	3.2	3.5	7.7	6.8
Niger	1.1	8.2	-0.4	0.2	-6.9	8.1	-4.0
Sierra Leone	-1.4	20.2	47.0	-11.1	-4.1	32.9	15.7
Somalia	-1.5	-0.2	2.6	1.2	-	-	-
Sudan	0.5	-0.3	-1.5	-	-	-	3.8
Togo	0.6	2.7	1.6	-	2.8	10.9	2.7
Uganda	-0.2	-	-1.1	0.6	11.7	12.4	19.2
Yemen	1.7	29.9	-10.8	33.1	0.2	-4.1	-10.2
OIC MICs							
Cameroon	8.6	0.2	-3.3	2.5	-0.9	6.3	4.8
Egypt	6.9	4.4	4.3	5.3	11.9	5.1	6.1
Guyana	2.1	-	4.8	4.9	43.0	29.7	15.7
Indonesia	0.9	2.7	2.8	3.9	3.8	8.9	7.0
Jordan	3.9	1.8	3.6	2.6	0.1	0.8	20.3
Lebanon	0.5	0.5	1.3	0.4	1.8	4.3	10.8
Malaysia	10.8	18.1	23.8	26.0	14.9	12.1	12.2
Morocco	1.4	3.8	3.7	7.5	8.8	5.0	15.6
Pakistan	1.3	3.3	2.8	3.5	4.6	9.0	7.0
Senegal	1.8	2.7	-0.5	0.1	12.6	1.2	17.4
Surinam	4.6	-30.9	-11.6	-4.6	-3.5	0.6	1.2
Syria	0.2	1.4	1.8	0.9	1.9	0.6	0.6
Tunisia	8.4	5.8	2.5	8.9	10.2	5.3	7.3
Turkey	0.8	2.0	2.0	2.3	1.9	1.6	1.6
OIC OECs							
Algeria	-	-	-	0.1	0.2	3.6	5.1
Bahrain	4.6	6.9	-0.3	-0.6	-2.7	6.2	3.4
Gabon	5.0	5.4	6.6	10.5	-8.4	26.4	12.2
Iran	-0.1	-0.1	-0.3	-0.7	-	-	1.5
Kuwait	-	0.2	-0.2	1.0	-	8.4	0.5
Libya	-3.2	1.4	1.7	1.7	1.9	5.7	0.3
Nigeria	3.6	28.4	15.2	26.3	50.5	21.3	7.2
Oman	6.4	6.8	10.2	4.4	3.8	2.9	1.3
Qatar	-	0.9	0.4	3.6	7.3	2.1	3.1
Saudi Arabia	17.0	-0.2	9.5	-0.3	1.6	-4.7	11.0
U.A.E	0.2	0.8	-1.8	1.6	0.6	1.2	0.9

Source: World Investment Development Report, various years. United Nations. New York and Geneva.

Note: The shaded rows indicate OIC countries with high FDI inflows to gross fixed capital formation ratios.