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South-South FDI flows: how big are they?

Dilek Aykut and Dilip Ratha [*]

This research note seeks to calculate the volume of South-South foreign direct investment flows in the 1990s. Indirect estimates, using data from several sources, suggest that more than one-third of such inflows into developing economies have originated in other developing economies. South-South foreign direct investment is driven by similar "push" and "pull" factors as drive North-South flows. A non-negligible part of South-South investment however may reflect round tripping of own capital motivated by policies that favour foreign investors over domestic ones.

Key words: foreign direct investment, transnational corporations, developing countries, round tripping

Introduction

Foreign direct investment (FDI) flows to developing countries and territories[1] increased from $43 billion in 1991 to $246 billion in 2000.[2] It is commonly believed that this surge in

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[1] In this research note, the term "developing countries" is used to denote both developing countries and territories, which together are also referred to as "developing economies".

[2] See UNCTAD, FDI/TNC database at: http://stats.unctad.org.

FDI flows to developing economies (the "South") originated in the developed countries (the "North"). The 1990s were also marked by a surge in FDI *outflows* from developing countries, from $12 billion in 1991 to $99 billion in 2000,[3] as a result of a rapid growth of income and wealth in many developing countries. Considering the economic slowdown in the North in the early 1990s, the increasing attractiveness of developing countries as a destination for FDI, and the rapid growth of intra-regional trade, it should be only natural to expect that some part of these investments from the South would flow to the other countries in the South. In other words, one would expect the share of South-South FDI flows in the inflows of developing countries to have increased in the 1990s.

This argument is consistent with the considerable literature on the increasing globalization of transnational corporations (TNCs) from the South. Several studies show that TNCs from the South have gradually accumulated technological capability and firm specific advantages and expanded their operations to other countries. According to the investment development path (IDP) approach, developed by John H. Dunning in 1979, these companies tend to invest initially in resource- and market-seeking activities in neighbouring or other developing countries, and then expand their presence worldwide (Dunning, 1979, 1993; Narula, 1995). Country case studies (Dunning *et al.*, 1997; Dunning and Narula, 1996; Zhang and van den Bulcke, 1996; Whitmore *et al.*, 1989; Lall, 1983) show that individual developing countries are at very different stages of their IDP.

Unfortunately, estimating the extent of such South-South FDI is not easy, as data are not available at the desired level of disaggregation. This research note pools together data from several sources: the World Bank, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and UNCTAD, to estimate indirectly South-South FDI flows in the 1990s. Such flows rose in the 1990s to account for more than one third of the FDI inflows reported by developing countries in 2000.

[3] *Idem.*

Highlighting the role of the South as a source of FDI is useful for several reasons. First, the growing importance of South-South FDI flows in the 1990s indicates that developing countries are more financially integrated with one another than previously believed. Second, South-South FDI may follow cycles different from the ones followed by North-South FDI. For example, South-South FDI flows may be more resilient to a crisis in a developing country. TNCs from the South often have lower overhead costs, and they often employ local managers. Therefore, they possess more expertise in dealing with the economic and political conditions of a host developing country than TNCs from developed countries (Wells, 1983). Third, the growing importance of South-South FDI indicates that investment promotion policies and agencies (in the South as well as the North) should target not only companies from the North, but also those from the South. This is particularly important for small economies, as TNCs from the South, because of the nature of their comparative advantages, tend to invest in countries that are at a similar or lower level of development than their home countries (Wells, 1983).

The structure of this research note is as follows. The next section describes two different ways of estimating South-South FDI flows and discusses the pitfalls of these methods. The subsequent section discusses possible causes behind the growth of South-South FDI flows. The last section concludes with a few remarks.

Estimation of South-South FDI flows

Definition of the "South"

The terms "North" and "South" have been used loosely in the literature to denote, respectively, the developed countries and the developing economies. This research note follows a categorization as described below (annex table 1):

- The "South" is defined as the 31developing countries for which reasonably detailed FDI data are available. These countries account for almost 90% of the total flows to developing countries.

- The "North" comprises 22 high-income OECD member countries. This group includes the donor countries belonging to the Development Assistance Committee (DAC) plus Greece and Iceland.

- The high-income non-OECD group comprises the 30 high-income economies that are not members of the OECD.

This classification follows the categories established by the World Bank, but it does not necessarily follow those established by the United Nations or UNCTAD (annex table 1). For example, the definition of the South as used in this research note excludes various newly industrializing economies such as Hong Kong (China), Singapore and Taiwan Province of China, as well as other high-income countries outside the OECD (e.g. Kuwait). Thus, the definition of the South in this study is narrower than, for example, in UNCTAD's *World Investment Report 2001* (UNCTAD, 2001).

Methodology

Conceptually, FDI flows can be represented for the above three groups in the following inflow-outflow matrix:

Table 1. Inflow-outflow matrix

Outflows/inflows	High-income-OECD or the North	High-income non-OECD	Developing countries or the South	Outflows
High-income-OECD or the North	F_{11}	F_{12}	F_{13}	O_1
High-income non-OECD	F_{21}	F_{22}	F_{23}	O_2
Developing countries or the South	F_{31}	F_{32}	$\boldsymbol{F_{33}}$	O_3
Inflows	I_1	I_2	I_3	Total flows $=I_{1+}\ I_{2+}\ I_3$ $=O_{1+}\ O_{2+}\ O_3$

Source: authors.

where F_{ij} represents total FDI flows from country group i to country group j, and I_i and O_i respectively indicate inflows to group i and outflows from group i. In this table, South-South FDI is represented by F_{33} and can be calculated using either the inflow equation (1) or the outflow equation (2) below:

$$I_3 = F_{13} + F_{23} + F_{33} \qquad (1)$$

$$O_3 = F_{31} + F_{32} + F_{33} \qquad (2)$$

Data

Data on inflows reported by countries tend to be more reliable than data on outflows, especially in the case of developing countries that have restrictions on the capital account or exchange controls, or preferential treatment for non-resident investment (see below for further discussion). So, one can compute South-South FDI flows using equation (1) as:

$$F_{33} = I_3 - F_{13} - F_{23} \qquad (3)$$

where

I_3 = Total FDI inflows to 31 developing countries.

F_{13} = Total FDI inflows from high-income OECD countries to 31 developing countries.

F_{23} = Total FDI inflows from high-income non-OECD countries to 31 developing countries.

The World Bank's *Global Development Finance database* and the IMF's *Balance of Payments Yearbook* provide total FDI inflows to each developing country, but they do not identify the source countries. The OECD's *International Direct Investment Database* provides FDI outflows from OECD member countries to these countries (F_{13}). FDI flows from high-income non-OECD countries (F_{23}) are not readily available; these are approximated as the difference between total outflows from high-income-non-OECD countries reported in the IMF's *International Financial Statistics*, and total inflows to high-income-OECD from high-income-non-OECD countries reported in the OECD database (i.e., O_2 - F_{21}).[4]

Results

The results on South-South FDI for the period 1994-2000[5] (table 2) show that, while both North-South and South-South FDI flows surged during that period, South-South FDI flows appear to have risen faster, from under $5 billion in 1994 to

Table 2. Estimation of South-South FDI flows, 1994-2000
(Billion dollars)

Item	1994	1995	1996	1997	1998	1999	2000
FDI inflows to developing countries:							
From all countries (1)	76.4	94.0	112.4	148.4	153.7	160.6	148.0
Less: from high-income-OECD countries (2)	42.7	51.3	58.8	69.8	74.1	93.6	85.5
Equals: from other than high-income-OECD countries (1-2)	33.7	42.7	53.6	78.6	79.5	66.9	62.5
Less: from high-income-non-OECD (3)	29.1	27.4	28.6	21.2	23.0	17.2	8.6
Equals: implied South-South Flows (1-2-3)	**4.6**	**15.3**	**25.0**	**57.4**	**56.6**	**49.7**	**53.9**
as share of total FDI flows to developing countries (%)	*6.0*	*16.2*	*22.3*	*38.7*	*36.8*	*31.0*	*36.4*

Source: authors' calculation.
[a] Adjusted for round tripping of flows between Hong Kong (China) and China (see below).

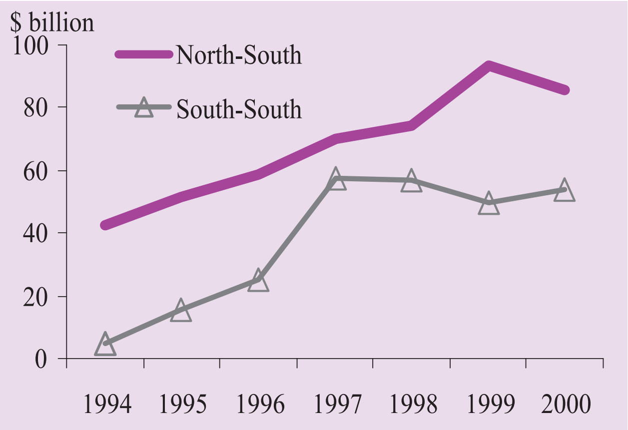
[4] Conceptually, $F_{23} = O_2 - F_{21} - F_{22}$, when using the categories of table 1. However, because of the lack of data, F_{22}, which is believed to be strictly positive, had to be ignored. The calculation, therefore, should overestimate F_{23} and underestimate South-South FDI flows. On the other hand, if outflows were underreported by high-income-non-OECD countries, this would overestimate South-South FDI flows. There is unfortunately no way for checking which of these opposite effects is stronger.

[5] Data for years earlier than 1994 are not available at the desired level of disaggregation. Also OECD data on FDI outflows are not yet available for years after 2000.

about over $50 billion in 2000 (figure 1). Indeed, at the end of the decade more than a third of FDI flows to developing countries could be estimated to have originated in other developing countries, as compared to negligible amounts in the early 1990s (figure 2).[6] In other words, in the early 1990s FDI flows to developing countries originated almost entirely in the North; but in the late 1990s, the share of North-South FDI in total FDI flows to the South appears to have declined to, and stabilized at, the 55-60% range.

Interestingly, South-South FDI appears to have remained resilient in the post-Asian crisis period, while North-South FDI from the United States, Japan and Germany declined (figures 1 and 3). The increase in North-South flows (seen in figure 1) was almost entirely due to a surge in Spain's mergers-and-acquisitions-related investments in Latin America (figure 3).[7]

Figure 1. FDI flows to developing countries



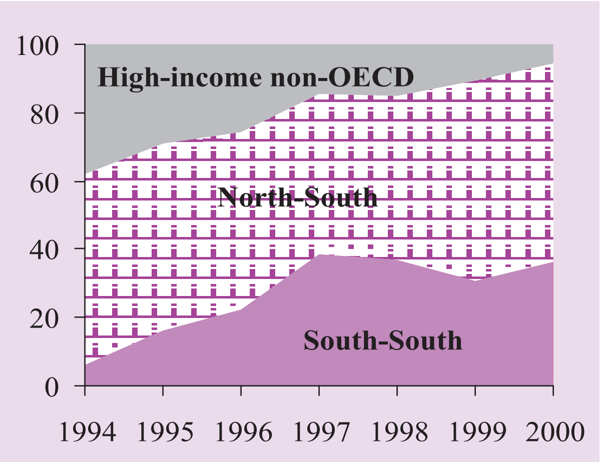
Source: authors' calculation.

[6] Beginning in 2003, the World Bank began to classify the Republic of Korea as a high-income OECD country. If the Republic of Korea were excluded from the "South" and included in the "North", the estimate of South-South FDI would decline marginally to $48 billion (or 34% of FDI flows received by developing countries) in 2000.

[7] Spain's total FDI outflows reached $53.1 billion in 2000, up from $4.1 billion in 1995. Between 1997 and 1999, Spain invested more in the South than in the North.

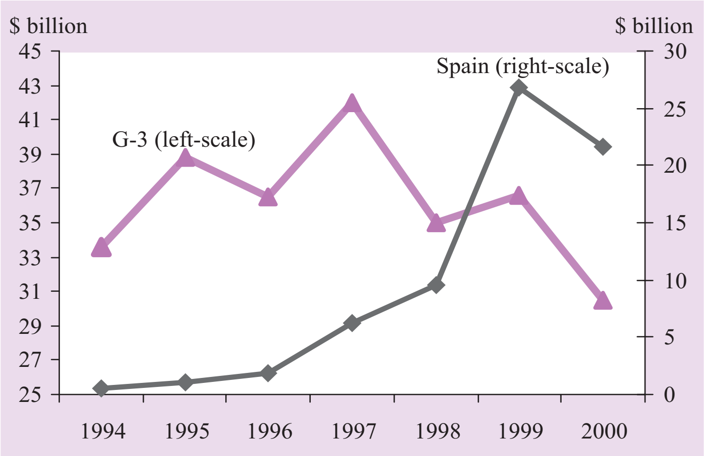
This is also evident from figure 4, which shows that FDI flows to developing countries outside Latin America declined during this period.

Figure 2. South-South and North-South shares
(Per cent)



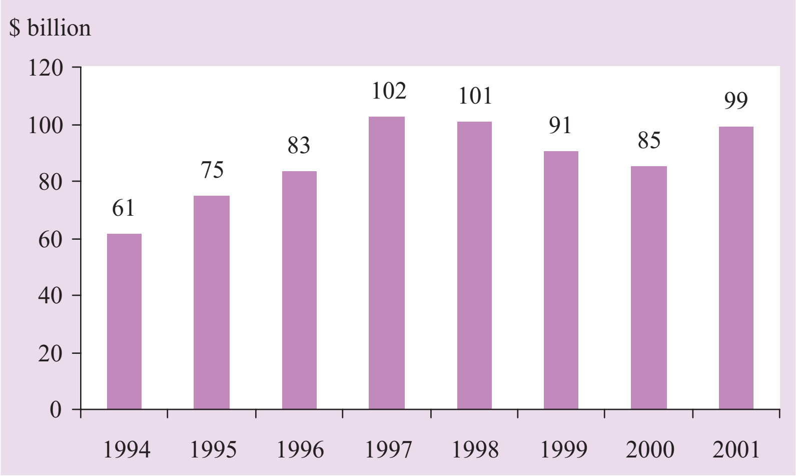
Source: authors' calculation.

Figure 3. Major North-South investors, 1994-2000
($ billion)



Source: OECD *International Direct Investment Database*.

Figure 4. FDI flows to developing countries, excluding Latin America and the Caribbean, 1994-2000
(Billion dollars)



Source: OECD *International Direct Investment Database*.

Some other studies have also noted an escalation of intra-regional FDI flows in Africa (UNCTAD, 1998) and Latin America (ECLAC, 1998) during the second half of the 1990s. The growth of South-South FDI is also supported by the fact that the *World Investment Report*'s transnationality index (UNCTAD, 2001) — an average of three ratios: foreign sales to total sales, foreign assets to total assets, and foreign employment to total employment — of TNCs from developing countries experienced significant increase in late 1990s, as these companies continued to expand their activities abroad (table 3). This surge may also be complemented by the emergence of the former centrally planned economies as outward investors: given their old political and economic links, this group of economies in transition tended to invest within its own group. According to UNCTAD (2001, p 114), the internationalization efforts of the top 25 TNCs of Central and Eastern Europe focus heavily on the European continent.

Such a tendency to invest in neighbouring countries at similar or lower levels of per capita income appears to be another interesting feature of South-South FDI. The competitive advantage of TNCs from South, small and medium-sized companies in particular, lies in their ability to function in a similar economic environment; these advantages are to be found only in countries with similar or relatively lower levels of development (Wells, 1983). Examples are investment by South African Breweries in Botswana, Lesotho, Swaziland, the United Republic of Tanzania, and Zambia; by Pepkor (South Africa's biggest retailer) in Zambia and Mozambique; and NetGroup (South African electricity company) in the United Republic of Tanzania. Similarly, Bulgaria has attracted FDI mostly from Turkey (Faf Metal, Ceylan Holding, Isiklar Holding, Ziraat Bank, Demir Bank), Hungary (Videoton), the Czech Republic (Pramet), the Russian Federation (Lukoil, Investment Bank and Vneshekonombank), and Slovakia (Skalica). According to the Fundación Invertir (Argentina), Chile and Brazil are among the major sources of FDI in Argentina (after United States, France and Spain).[8]

The Republic of Korea, China, Malaysia, South Africa, and Chile are major sources of FDI in the developing world. However, the list of developing economies investing in other developing economies is by no means limited to these countries. For example, according to UNCTAD data, the number of developing countries reporting positive FDI outflows rose from 43 in 1990 to 77 in 1999 (UNCTAD, 2001).

In the late 1990s, as the technology boom collapsed and privatization programmes in many developing countries encountered difficulties (re-nationalization, renegotiation, disappointing returns; see Lora and Panizza, 2002), some global infrastructure TNCs began to withdraw from the South. The resulting void was in part filled by TNCs from the same region.

[8] Leading Brazilian TNCs in Argentina include Petrobas (fuel and petrochemicals), Brahma (beer) and Banco Itau (banking). The foremost Chilean investors are Gener (thermoelectric power), Masisa (chipboard), Luksic Group (beer) and Grupo Ibáñez (supermarkets).

For example, NetGroup (South Africa) and Electricity Distribution Management (Namibia) are expanding operations in southern and eastern Africa. The IPS Power affiliate of the Aga Khan Foundation is investing in Tajikistan, and Barmek Holding (Turkey) in Azerbaijan.

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Table 3. The transnationality index of the largest TNCs from the South, 1993 and 1999
(Per cent)

Country	1993	1999
India	6.4	9.6
Philippines	6.9	25.0
Chile	12.1	35.4
Mexico	12.5	48.0
Brazil	17.4	30.2
Malaysia	20.0	24.1
Republic of Korea	20.2	27.8
Argentina	..	24.5
South Africa	..	44.3
Venezuela	..	29.8
Latvia	..	87.3
Russian Federation	..	42.7
Czech Republic	..	37.7
Hungary	..	34.9
Croatia	..	34.1
Slovenia	..	32.2
Slovakia	..	17.0
Poland	..	5.4
Romania	..	3.7

Source: UNCTAD, 2001.

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Accuracy of the estimates

Although care was taken to use the most accurate data possible in computing South-South FDI flows, the estimates may suffer from the following weaknesses:

- outflows may be underreported even by high-income-OECD countries;
- inflows may be underreported by some developing countries;
- round-tripping of flows can lead to an overestimation of South-South FDI flows;
- transactions channelled through offshore financial centres may produce errors in the estimates if some of these flows are wrongly misclassified as FDI; and
- FDI from the North may get channelled through a developing country, causing an overestimation of South-South flows.

These problems are discussed one-by-one below.

Underreporting of outflows

As mentioned earlier, South-South FDI flows (F_{33}) could have been computed using equation (2). Such a calculations, too, would show a significant increase in South-South FDI flows during the second half of the 1990s. That volume, however, would be much smaller ($12 billion in 1998) than the results obtained using equation (1), which considered the scenario of underreporting of outflows by source countries.

The problem of under-reporting of FDI outflows is believed to be particularly acute in the case of developing countries. Some developing countries (even major emerging markets like Malaysia and Mexico) do not identify FDI outflows in their balance-of-payments statistics. Moreover, underreporting of outflows is pervasive, particularly when outward-investing TNCs attempt to avoid capital and exchange controls, or high taxes on the investment income. Lax accounting standards, weak tax administration and differences in the definition of FDI between the source and destination countries introduce further “noise” in the FDI data.

Evidence of underreporting can be seen by comparing FDI inflows reported by the United States with outflows to the United States reported by developing countries. Mexico’s FDI outflows were under $1 billion in 2000 (UNCTAD, 2002a), while the United States reported inward FDI from Mexico of $5.3 billion. Hungary reported a total FDI outflow of $0.3 billion in 2001,[9] while the United States alone reported receiving $5.9 billion from Hungary. Other examples of underreporting abound. Investors from the Islamic Republic of Iran purchased Irish Telecom Eireann for $4.4 billion in 1999 – this transaction was not reported at all in the statistics of the Islamic Republic of Iran. China’s outward FDI numbers are much smaller than those reported as inflows from China in Hong Kong (China)’s official statistics (more discussion on this issue provided below).

There may be conceptual problems in identifying FDI outflows. By definition, equity investment in excess of 10% of the outstanding stock of an entity is considered as direct investment. While there is little confusion about this rule, it may be easier for the government of a host country to judge (than for the government of the home country) whether a particular equity investment meets this criterion. If so, this would cause

[9] While Hungary reported less than $1 billion, United States reported inflows from Hungary as $0.8 in 1999 and $2.2 billion in 2000.

underreporting of outflows in the source country. These measurement problems are likely to be more acute in the case of the developing countries that have weaker accounting systems than developed countries.

Underreporting of inflows by developing countries

FDI inflow data are also often underreported by host countries. Two examples are India and Indonesia. In difference with the IMF definition of FDI, until recently India's FDI statistics excluded reinvested earnings, other direct investment (intra-company loans between the parent companies and the foreign affiliates), data on branches and associates, and investments by offshore and domestic venture-capital funds set up by foreigners (EIU, 2002). If these items were taken into account, India's actual FDI inflow would rise from $2-3 billion per year reported to as much as $8 billion, the latter representing about 1.7% of the gross domestic product (EIU, 2002). The Government of India has recently proposed to adopt the IMF's definition of FDI as required under the IMF's Special Data Dissemination Standard. As part of this exercise, the Reserve Bank of India revised up in 2003 its FDI inflow statistics upwards by more than $1 billion.

Similarly, Indonesia's FDI is underreported. Indonesian balance-of-payments data indicate that, between 1998-2001, total *disinvestments* (negative FDI inflows) in the country reached over $10 billion. While this is in part consistent with the decline in outward FDI to Indonesia reported by high-income OECD countries (these countries accounted for 70% of total FDI stock in Indonesia until 1998), it is not consistent with the fact that the volume of their total FDI still remained positive. One reason for this discrepancy may be that Indonesia does not include reinvested earnings as FDI inflows (IMF, 2001).

Round tripping of FDI

If non-resident investors are offered preferential treatment in taxation, land rights, exchange controls etc., resident investors may have an incentive to take capital across the border and bring it back as inward FDI. In such cases, capital may leave the country in the form of bank deposits (or other means), but would return as FDI inflows. Such round tripping may generate distortions in FDI statistics. For example, if round tripping uses another developing country, then such flows would be included in estimates of South-South FDI flows, even though there is no net inflow into the developing country concerned. If round tripping uses a developed (either high-income OECD or non-OECD) country, that would only be included in total inflows reported by the developing country, but not in South-South FDI (provided that the developed country reports outflows accurately). It may also well be that the developing country which is the source of round-tripping outflows does not have consistent reporting on the phenomenon (as in the case of round-tripping of flows between China and Hong Kong (China), for example), and the estimation of South-South FDI may be affected.

Round tripping of capital flows between China and Hong Kong (China)

FDI inflows to China surged in the 1990s, especially since 1993, as the country accelerated market reforms and introduced incentives for FDI, including concessions on tax, leasing of land and property, government guarantees for investments, and special arrangements regarding the retention and repatriation of foreign exchange. Such discriminatory treatment of foreign capital relative to resident capital is believed to have encouraged Chinese firms to move money offshore and then bring it back to China disguised as FDI (Sicular, 1998). Some early studies estimated such round tripping to account for nearly a quarter of FDI inflows to China in 1992 (Lardy, 1995; Harrold and Lall, 1993). The extent of round tripping may have increased in recent years.

Throughout the 1990s, FDI inflows to China originated mostly outside the high-income OECD countries, notably in Hong Kong (China). For example, FDI inflows from Hong Kong

(China) constituted nearly half of total FDI flows to China in 1996. This share declined after 1997, when Hong Kong (China) was returned to China, to below 40% by 2000 (table 4); but in the meanwhile, this decline was offset by a comparable increase in FDI inflows from the British Virgin Islands (suggesting round tripping through this offshore financial centre). FDI inflows from Hong Kong (China) and British Virgin Islands appear to be highly correlated with outflows from China in the form of "other investment assets" – mostly bank deposits held abroad by Chinese residents – and errors and omissions in China's balance of payments (figure 5).

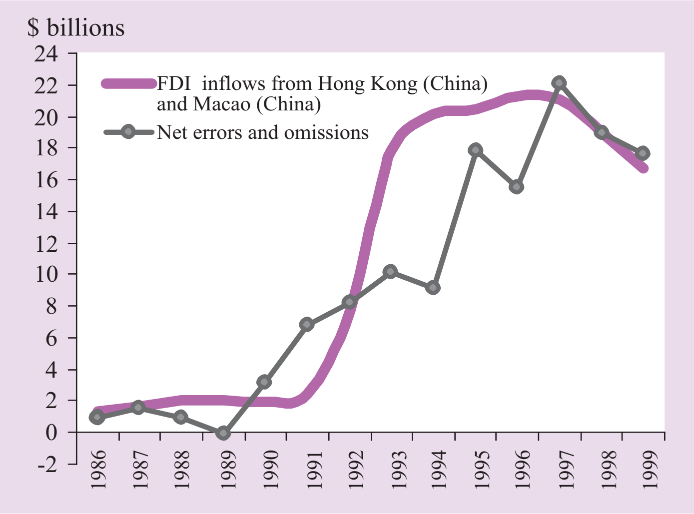
Table 4. FDI inflows of China by economy of origin, 1996-2000
(Per cent of total FDI inflows)

Economy	1996	1998	1999	2000
Hong Kong (China)	49.56	42.29	40.38	37.89
British Virgin Islands	-	9.21	6.56	9.39
United States	8.25	8.91	10.40	10.72
Singapore	-	7.78	6.52	5.31
Japan	8.82	7.77	7.34	7.13
Taiwan Province of China	8.33	6.66	6.41	5.61
Korea, Democratic People's Republic	0.03	4.12	3.15	3.64
Germany	-	1.68	3.39	2.55
Netherlands	-	1.64	1.34	1.93
France	1.02	1.63	2.18	2.09
Oceania	-	1.22	1.26	1.70
Macau, China	-	0.96	0.76	0.85
Malaysia	-	0.78	0.59	0.50
Australia	0.46	0.39	0.41	0.49
Canada	0.81	0.45	0.50	0.44
Italy	0.40	0.39	0.30	0.33
Russian Federation	0.05	0.03	0.03	0.03
South Africa	-	0.01	0.01	0.01
Sweden	0.14	-	0.25	0.25
United Kingdom	3.12	-	-	-

Source: China, Ministry of Foreign Trade and Economic Cooperation.

Figure 5. Round tripping between China and Hong Kong (China), 1986-1998

(Billion dollars)



Source: IMF International Financial Statistics, and China, Ministry of Foreign Trade and Economic Cooperation.

Hong Kong (China), in turn, reported large amounts of FDI inflows from China and offshore financial centres such as Bermuda and the Virgin Islands during this period. Moreover, OECD sources reported only small amounts of inward FDI in Hong Kong (China), thus ruling out the possibility that high FDI numbers reported by Hong Kong (China) reflected routing of investments to China. It appears, therefore, that round tripping of investment in China was substantial in recent years.

In 2000, Hong Kong (China) reported a record $ 46 billion outflows of FDI to China, an increase of about $ 36 billion compared to the previous year,[10] apparently funded by a sharp increase in FDI inflows from British Virgin Islands (table 5).

[10] The spike in FDI outflows was entirely caused by a $32 billion deal by China Mobile (Hong Kong), which bought seven mobile phone networks in the People' Republic of China in 2000.

However, China did not report any significant increase in FDI inflows from Hong Kong (China) in this year and, in fact, reported a decline in total FDI inflows. Calculations of South-South FDI flows for 2000 compensated for this misreporting (presumably because of round-tripping) by assuming that Hong Kong's (China) outflows to China remained the same as in 1999.

Table 5. FDI inflows and outflows reported by Hong Kong (China), 1999-2000
(Billion dollars)

	Inflows			Outflows		
Economy	1999	2000	Change (%)	1999	2000	Change (%)
China	5.0	14.2	9.2	10.1	46.4	36.3
British Virgin Islands	6.3	30.6	24.3	4.3	9.1	4.8
Singapore	0.8	7.8	7.0	0.5	0.4	-0.1
Bermuda	3.2	4.7	1.6	0.8	1.6	0.8
Total	24.6	61.9	37.4	19.3	59.4	40.1

Source: Hong Kong Census and Statistics Department.

Role of offshore financial centres

FDI outflows from offshore financial centres may be estimated on the basis of data reported in UNCTAD's *World Investment Reports*. However, outflows reported by some offshore financial centres may be underestimated. The inconsistency between inflow and outflow statistics is evident when looking at United States data. The latter data series distinguish between: (i) the residence of the firm making an investment (reported as the source country in the usual statistics); and (ii) the residence of the owners of a firm, and hence the original source of the funds (referred to in the United States reports as the "ultimate beneficiary owner"). For example, in 2001, FDI to the United States from Switzerland equalled \$56.3 billion. However, using the ultimate beneficiary criterion, FDI from Switzerland was close to zero. The bulk of the funds reported as FDI from Switzerland actually originated in a third country and were channelled through Switzerland. Even this correction, however, cannot always identify the source of FDI flows. For example, using the ultimate beneficiary criterion, FDI from Bermuda and Hong Kong (China) totalled $42 billion in 2001 (table 6). However, it is unlikely that these financial centres were the original source of substantial amounts of FDI.

Table 6. FDI inflows into the United States and ultimate beneficiary owners, 2001
(Billion dollars)

Home economy	FDI inflows	Ultimate beneficiary
Bermuda	-2.8	19.5
Hong Kong (China)	-	22.4
Switzerland	56.3	-0.6

Source: United States Department of Commerce.

Financial centres also may distort the global amount of FDI flows. For example, during 1999-2000, Belgium-Luxemburg reported huge surges in both inward and outward FDI flows. According to the OECD database, this surge was almost entirely in financial activities (most likely financial intermediation). These transactions increased the total size of global FDI flows by about $200 billion.

Routing FDI through locations in the South

The South-South FDI flows reported above include cases such as when an affiliate or a branch of a United States company – e.g. located in Mexico – undertakes FDI in Brazil (say, to exploit brand name recognition or some advantages offered by bilateral arrangements between countries in the South). Is this really a South-South flow or a form of North-South flows? It is empirically difficult to separate this effect in the estimates of South-South FDI. Nevertheless, even that type of South-South FDI, too, fosters global economic integration.

Factors behind the rise in South-South FDI flows

There are several "push" factors that motivate companies from the South to invest abroad and "pull" factors that attract them to other developing countries. In fact, most of these factors had been in place already decades before. What triggered the recent South-South FDI surge, however, was the rising wealth in some emerging economies that increased the supply of capital, and capital account liberalization in other developing countries that enabled TNCs to invest into or from developing countries.

Companies from the South, similar to those from the North, are searching for higher returns and lower risks through portfolio diversification. Faced with increased competition and limited market-growth opportunities in domestic markets, these TNCs are investing in market-seeking activities in other developing countries.[11] Some recent examples include Malaysian telecommunication and leisure TNCs' investment in Asia, that of South African retailing and brewing companies in Africa, and that of Mexican retail stores in other Latin American countries.

Other push factors are the need to improve export competitiveness and to defend the exports markets after increased competition (Wells, 1983). Some TNCs from developing countries invest in efficiency-seeking activities abroad following an erosion in their export competitiveness (due to, say, currency appreciation; see Mirza, 2000; Whitmore *et al.*, 1989; Lall, 1983). Tariff and non-tariff barriers to imports and exports imposed on a (developing) country may also

[11] The reasons for the increase in North-South flows include "push" factors such as economic slowdown and lowering of interest rates in capital-exporting developed countries. Other reasons for the rise in inflows are "pull" factors in developing countries such as high growth rates, capital account opening, liberalization of the domestic economy and other policy reforms (World Bank, 1997; Calvo *et al.*, 1993; Chuhan *et al.*, 1998; Ul Haque *et al.*, 1997; Dasgupta and Ratha, 2000). For a detailed survey of literature and empirical evidence on trends and causes of capital outflows from developing countries, see World Bank, 2002a, chapter 3; Powell *et al.*, 2002.

encourage its TNCs to invest in other countries as a means of obtaining or delivering goods.[12]

Procurement of raw materials (including oil and gas) is the other push factor behind the rise of outflows from the South. Demand for raw materials has increased in tandem with economic development and population in developing countries. In order to secure provision of these materials, some TNCs from developing countries invest in critical inputs such as oil in other developing countries. Recent examples are China's FDI in pulp projects in Chile and the Russian Federation, iron ore and steel mills in Peru, oil in Angola and the Sudan (Chhabra, 2001; Liu, 2001), and Malaysian State-owned Petronas' investments in South Africa, Viet Nam, Cambodia and the Lao People's Democratic Republic.

Certain developing-country governments offer fiscal and other incentives to outward investing TNCs. For example, the Government of China is promoting outward FDI by providing loans on preferential terms, tax rebates, and investment insurance (UNCTAD, 2002b). The Government of Malaysia encourages South-South FDI flows through special deals signed with countries like the Philippines, Viet Nam, India and the United Republic of Tanzania (Mirza, 2000).

Major "pull" factors for FDI flows in developing countries include low labour costs, market access both the domestic and export markets through preferential treatments, investment incentives, capital account liberalization and financial deregulation in developing countries in the early 1990s.

In addition to these, there are other pull factors for South-South FDI, however, including familiarity with the local business environment (for example, through trading relations), geographic proximity, ethnic and cultural ties. The cost of acquiring reliable information about foreign markets can be high

[12] Such "barrier hopping" is discussed in Kumar, 1996; UNCTAD, 2002b.

for relatively small TNCs from the South. Thus, they tend to invest in neighbouring countries where they have acquired certain familiarity through trade, or ethnic and cultural ties. For example, because of ethnic ties, some ethnic Korean companies invest in China and Kazakhstan, and some ethnic Chinese companies invest heavily in the East Asia and Pacific region. Interestingly, sometimes ethnic and cultural ties can triumph over the proximity problems. In recent years, TNCs from China, Malaysia and the Republic of Korea have become significant players in construction and communications in Africa as formerly resident Asians returned large amounts of private capital to eastern and southern Africa (Bhinda *et al.*, 1999; Padayachee and Valodia, 1999; Kimei *et al.*, 1997). Studies show that the importance of ethnical ties are much more relevant for Asian TNCs than for Latin American ones, although significance declines as TNCs gain experience in particular countries (Wells, 1983; Kumar, 1996; Lecraw, 1996).

Based on a literature survey, table 7 provides a summary of these push and pull factors. Each category is further separated into structural, cyclical and institutional or policy factors.[13] In addition to the above "push-pull" factors, South-South FDI may have been guided by strategic or geopolitical considerations. Preferential treatment of FDI may also have encouraged round tripping of resident capital, which would imply an increase in South-South FDI flows (but no change in net inflows).

Conclusion

South-South FDI is difficult to estimate, but indirect estimates based on combined data from the World Bank, IMF, OECD and UNCTAD indicate the following patterns:

- South-South FDI flows rose faster than North-South flows in the 1990s; by 2000, they accounted for more than one-third of FDI flows to developing countries.

[13] A similar format was used in Dadush, Dasgupta and Ratha, 2000. Note that these categories are not watertight.

Table 7. Factors affecting South-South FDI in the 1990s

Item	Structural factors	Cyclical factors	Institutional/policy factors
Push factors	Rising wealth in some emerging market economies increased supply of capital.	Low interest rates and low growth in industrial countries encouraged diversion of outflows from developing countries to other fast-growing developing countries.	Capital account liberalization allowed resident companies to invest abroad.
	Rising costs of labour and non-tradables encouraged relocation of production units to cheaper locations.		Growth of South-South trade through regional trading arrangements was often associated with investment agreements.
	Domestic deregulation to improve competition by breaking up monopolies prompted some large companies to branch into other other countries.		Tariff and non-tariff barriers to trade encouraged the relocation of production units to other developing countries.
	New technology and telecommunications improved information sharing and reduced transaction costs.		Government policies encouraging the outflow of investment.
Pull factors companies	Large and growing domestic markets.		Permitting foreign ownership of domestic
			encouraged FDIthrough mergers and acquisitions.
	Geographic proximity and ethnic and cultural ties.		Special tax and other incentives to attract FDI attracted more foreign investment.
	Supply of cheap labour.		
	Abundance in raw materials.		Preferential treatment of FDI over resident investment encouraged round tripping of resident capital.
			Export markets through preferential treatment.
Strategic reasons	The desire to procure critical inputs such as oil.		Geopolitical considerations.

Source: authors.

- The rise in South-South FDI flows was motivated by similar push and pull factors and similar structural, cyclical and policy factors as the surge in North-South FDI flows in the 1990s. These factors included increased wealth in many emerging market economies, TNCs' search for higher risk-adjusted returns through diversification; capital-account opening in some developing countries that allowed local companies to invest abroad; and financial deregulation in host countries that allowed foreigners to own domestic companies. Regional trading arrangements also contributed to the growth of South-South FDI.
- A large part of South-South FDI may also be of a round-tripping nature, motivated by a desire to receive preferential treatment offered by many governments (e.g. in China) to foreign investors.

The growing importance of South-South FDI flows in the 1990s indicates that developing countries were more financially integrated with one another than previously believed. Thus, a typical developing country had access to more sources of investment in the late 1990s than before. This means that investment promotion agencies in developing countries should target not only investors in the North, but also from the South. This also applies to investment promotion agencies in the North.

The findings of this research note, however, should be treated with some degree of caution. One might question the quality and consistency of data reported by various organizations. Also, the above estimates of South-South FDI flows may not be accurate if outflows are underreported by some countries (offshore financial centres in particular); and to the extent that there is a round tripping of flows as in the case of China. Moreover, these estimates do not distinguish between North-South flows routed through locations in the South (e.g. a Mexican affiliate of a United States company investing in Brazil) and genuine South-South flows.■

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Annex table 1. Definition of country groups used in this research note

Developing countries	High-income OECD countries	High-income non-OECD economies
Algeria	Australia	Andorra
Argentina	Austria	Aruba[b]
Brazil	Belgium-Luxembourg	Bahamas[b]
Bulgaria[a]	Canada	Barbados[b]
Chile	Denmark	Bermuda[b]
China	Finland	Brunei Darussalam[b]
Colombia	France	Cayman Islands[b]
Costa Rica	Germany	Channel Islands
Czech Republic[a]	Greece	Cyprus[b]
Egypt	Iceland	Faeroe Islands
Hungary[a]	Ireland	French Polynesia[b]
India	Italy	Greenland[b]
Indonesia	Japan	Guam[b]
Iran, Islamic Republic of	Netherlands	Hong Kong, China[b]
Korea, Republic of	New Zealand	Israel
Libyan Arab Jamahiriya	Norway	Kuwait[b]
Malaysia	Portugal	Liechtenstein
Mexico	Spain	Macao, China[b]
Morocco	Sweden	Malta
Panama	Switzerland	Monaco
Philippines	United Kingdom	Northern Mariana Islands[b]
Poland[a]	United States	Netherlands Antilles[b]
Romania[a]		New Caledonia[b]
Russian Federation[a]		Qatar[b]
Saudi Arabia		Singapore[b]
Slovakia[a]		Slovenia[c]
South Africa		United Arab Emirates[b]
Thailand		Virgin Islands (United States)[b]
Turkey		Taiwan Province of China[b]
Ukraine[a]		
Venezuela		

[a] Classified by UNCTAD not as a developing but Central and Eastern European country.

[b] Classified by UNCTAD as a developing economy.

[c] Classified by UNCTAD not as a "high-income non-OECD" but Central and Eastern European country.